Supreme Court, U.S.
FILED

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No. _____

# In the Supreme Court of the United States

DOUGLAS R. COLKITT,
*Petitioner*,

v.

GFL ADVANTAGE FUND, LTD.,
*Respondent*.

ON PETITION FOR WRIT OF CERTIORARI
TO THE UNITED STATES COURT OF APPEALS
FOR THE THIRD CIRCUIT

## PETITION FOR WRIT OF CERTIORARI

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## QUESTIONS PRESENTED

I. Are entities that have been incorporated under the laws of the British Virgin Islands either "citizens" or "subjects" of a foreign state, so as to give rise in cases brought by such entities in federal court to subject matter jurisdiction under Art. III, § 2 of the United States Constitution and 28 U.S.C. § 1332(a)(2)?

II. Should a federal court of appeals grant a timely petition for rehearing in light of a recent controlling decision and clarification of law from this Court that was not considered by the court of appeals in rendering its decision and that is contrary to its judgment and opinion?

## PARTIES TO THE PROCEEDINGS

### Petitioner

Petitioner is Douglas R. Colkitt, an individual citizen of the United States. Douglas R. Colkitt was the Defendant in the United States District Court for the Middle District of Pennsylvania, and the Appellant in the United States Court of Appeals for the Third Circuit.

### Respondent

Respondent is GFL Advantage Fund, Ltd., a British Virgin Islands corporation. Respondent was the Plaintiff in the United States District Court for the Middle District of Pennsylvania, and the Appellee in the United States Court of Appeals for the Third Circuit.

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Douglas R. Colkitt respectfully requests that this Court issue a writ of certiorari to review the judgment entered in this case by the United States Court of Appeals for the Third Circuit.

## OPINIONS BELOW

The decision of the court of appeals denying the petition for rehearing and rehearing *en banc* is unreported and is reproduced at App. A at 1a. The opinion of the court of appeals on the merits is reported at 272 F.3d 189 (3d Cir. 2001), and is reproduced in App. B at 3a. The opinions and orders of the United States District Court for the Middle District of Pennsylvania are unreported and are reproduced in App. C at 50a, 81a, 83a, 109a.

## STATEMENT OF JURISDICTION

The opinion of the United States Court of Appeals for the Third Circuit was issued November 16, 2001. A timely petition for rehearing and rehearing *en banc* was denied by that court on December 21, 2001. Although subject matter jurisdiction is contested, this Court has jurisdiction to review the court of appeals' order under 28 U.S.C. § 1254(1).

## CONSTITUTIONAL AND STATUTORY PROVISIONS INVOLVED

U.S. Const. Art. III, § 2 is reproduced in App. E at 111a.

28 U.S.C. § 1332(a)(2) is reproduced in App. E at 112a.

15 U.S.C. § 78j(b) is reproduced in App. E at 113a.

15 U.S.C. § 78cc(b) is reproduced in App. E. at 114a.

## STATEMENT OF THE CASE

### A. The Proceedings Below

This case arises from two loans together totaling $13 million made by GFL Advantage Fund, Ltd. ("GFL"), a corporation under the laws of the British Virgin Islands, to Douglas R. Colkitt, a Pennsylvania resident at the time the loans were made. The notes representing the loans were exchangeable into shares of common stock owned by Colkitt in two small capitalization companies - EquiMed, Inc. ("EquiMed") and National Medical Financial Services Corporation ("National Medical"). The notes gave GFL the option of purchasing Colkitt's shares of EquiMed and National Medical stock in exchange for retiring the debt represented by the notes at an "exchange price" based upon the future market price of the stocks. The lower the market price on the date GFL demanded exchange, the more shares Colkitt would have to sell GFL to retire the same dollar amount of debt (because each share would be worth less).

GFL sued Colkitt in the United States District Court for the Middle District of Pennsylvania for defaulting on the notes. Colkitt asserted affirmative defenses and counterclaims under the anti-fraud provisions of the federal and state securities laws, including §§ 10(b) and 29(b) of the Securities Exchange Act of 1934 ("Exchange Act"), and for common law fraud. Colkitt made two types of claims - market manipulation and securities fraud. Colkitt's market manipulation claim alleged that GFL had engaged in an unlawful scheme of short selling EquiMed and National

Medical stock just prior to the dates GFL demanded exchange of the debt for stock for the purpose of depressing the market price and forcing Colkitt to sell more shares under the notes. Colkitt's securities fraud claim alleged that, regardless of any market manipulation that may have occurred, GFL unlawfully failed to disclose that (a) GFL intended to short sell the stocks at the time it entered into the exchangeable notes, and (b) GFL had in fact short sold thousands of shares just prior to each demand by GFL to exchange the debt for Colkitt's shares.

The district court granted GFL's motion for summary judgment, entering judgment against Colkitt and in favor of GFL in the amount of $21,121,989.39. The court of appeals affirmed. As to Colkitt's market manipulation claim, the court of appeals ruled that even though GFL sold short 78,700 shares of EquiMed and 62,500 shares of National Medical in the period prior to demanding exchange of the debt for stock, Colkitt's claim fails because he did not produce evidence that these short sales injected inaccurate information into the market. 272 F.3d at 210-212. As to Colkitt's securities fraud claim, the court of appeals ruled that even though Colkitt created a genuine issue of fact that GFL's short sales depressed share prices and caused Colkitt to sell GFL additional shares for no additional consideration, GFL did not have a duty to disclose the short sales to Colkitt. Id. at 206 n.6 & 213-14. The court of appeals reasoned that GFL had no such duty because the short sales did not produce inaccurate or tainted market prices for EquiMed and National Medical. Id.

Colkitt sought rehearing and rehearing *en banc* only as to his securities fraud claims. Colkitt argued that the court of appeals decision is contrary to this Court's recent unanimous decision in The Warf (Holdings) Ltd. v. United Int'l.

Holdings, Inc., 121 S. Ct. 1776 (2001), which was decided after the appellate briefs were filed and was not considered by the court of appeals in rendering its decision. The Warf clarifies the law under § 10(b) of the Exchange Act by establishing that there is a duty to disclose information that makes a securities option contract, such as the exchangeable notes, misleading even if the concealed information had no affect upon the market price of the underlying securities. By ruling that there was no duty to disclose because market prices had not been artificially tainted, the court of appeals failed to consider, as required by The Warf, that the short sales misled Colkitt about the value of the notes themselves as opposed to the value of the underlying stocks.

The court of appeals denied Colkitt's petition for rehearing and rehearing *en banc* without opinion and refused to reconsider its ruling in light of The Warf.

### B. Subject Matter Jurisdiction

At no time during the proceedings below did either the parties, the district court, or the court of appeals question subject matter jurisdiction. All of GFL's claims arise under state law, and GFL invoked federal alienage jurisdiction in its complaint under 28 U.S.C. § 1332(a)(2) as a citizen or subject of a foreign state suing a resident of Pennsylvania.

A challenge by Colkitt to subject matter jurisdiction during the proceedings below was foreclosed by a then-controlling decision of the Third Circuit in Southern Cross Oversees Agencies, Inc. v. Wah Kwang Shipping Group, Ltd., 181 F.3d 410, 418-19 (3d Cir. 1999). In that case, the Third Circuit ruled that entities incorporated under the laws of British Dependent Territories are "subjects" of the United Kingdom for purposes of 28 U.S.C. § 1332(a)(2) and may sue

in federal courts. The British Virgin Islands, where GFL was incorporated, is, like Hong Kong, a British Dependent Territory. See, Chase Manhattan Bank v. Traffic Stream (BVI) Infrastructure, Ltd., 251 F.3d 334, 337 (2d Cir. 2001). Hence, under Southern Cross, subject matter jurisdiction under § 1332(a) would be present in the instant case and not subject to challenge in the district court.

Two weeks after the court of appeals denied Colkitt's petition for rehearing, this Court called into doubt the Third Circuit's decision in Southern Cross by granting a writ of certiorari in Chase Manhattan Bank v. Traffic Stream (BVI) Infrastructure, Ltd.. The United States Court of Appeals for the Second Circuit in that case held that British Virgin Islands corporations like GFL are neither "citizens" nor "subjects" of the United Kingdom for purposes of alienage jurisdiction and that federal courts lack subject matter jurisdiction under 28 U.S.C. § 1332(a) to entertain suits initiated by them. Id. 251 F.3d at 337. This is at odds with the Third Circuit in Southern Cross and the assumption of jurisdiction in this case, as well as the Seventh Circuit in Wilson v. Humphreys (Cayman) Ltd., 916 F.2d 1239, 1243 (7th Cir.1990), cert. denied, 499 U.S. 947 (1991), and the Fourth Circuit in Koehler v. Dodwell, 152 F.3d 304, 308 (4th Cir.1998). On January 4, 2002, this Court granted a writ of certiorari in Chase Manhattan to resolve this circuit split and consider this important question of federal subject matter jurisdiction. Chase Manhattan Bank v. Traffic Stream (BVI) Infrastructure, Ltd.,122 S. Ct. 803, 70 U.S.L.W. 3317 (Jan. 4, 2002). If this Court affirms the Second Circuit in Chase Manhattan, then subject matter jurisdiction will be lacking in the instant case and the judgment of the district court must be reversed and the case dismissed.

## REASONS FOR GRANTING THE WRIT

### I.

### This Court Granted A Writ Of Certiorari In Chase Manhattan To Resolve The Same Important Question Of Alienage Jurisdiction Presented Here

On January 4, 2002, this Court granted a writ of certiorari in Chase Manhattan Bank v. Traffic Stream (BVI) Infrastructure, Ltd., 251 F.3d 334 (2d Cir. 2001), cert. granted, 122 S. Ct. 803, 70 U.S.L.W. 3317 (Jan. 4, 2002), to resolve the identical issue presented by this case: Whether a British Virgin Islands corporation is a "citizen" or "subject" of a foreign state for purposes of subject matter jurisdiction under 28 U.S.C. § 1332(a)(2). The same weighty reasons that this Court considered sufficient to grant the writ of certiorari in Chase Manhattan are also present to an equal degree in this case.

In Chase Manhattan, the question of subject matter jurisdiction was raised *sua sponte* by the Second Circuit on appeal of a district court order granting summary judgment in favor of a New York corporation and against a British Virgin Islands corporation that had defaulted on a note in an aggregate amount of $199,000,000. 251 F.3d at 225-36. Finding that British Virgin Islands corporations are neither citizens nor subjects of a foreign state under 28 U.S.C. § 1332(a), the court of appeals reversed summary judgment and dismissed the case for lack of subject matter jurisdiction. Id. at 337. In the instant case, summary judgment was granted in favor of a British Virgin Islands corporation (GFL) and against a Pennsylvania resident. The question of whether British Virgin Islands corporations are citizens or subjects of

a foreign state under 28 U.S.C. § 1332(a) is identical and of the same consequence.

Certiorari jurisdiction is warranted because there is a split among the circuits, certiorari has been granted in a virtually identical case, and the question involves subject matter jurisdiction and the status of foreign entities under federal law.

## II.

### Lack Of Subject Matter Jurisdiction Can Be Raised For The First Time In This Court

In Insurance Corp. of Ireland, Ltd. v. Compagnie des Bauxites de Guinee, 456 U.S. 694 (1982), this Court explained the unique nature of subject matter jurisdiction as follows:

> Subject-matter jurisdiction . . . is an Art. III as well as a statutory requirement; it functions as a restriction on federal power, and contributes to the characterization of the federal sovereign. Certain legal consequences directly follow from this. For example, no action of the parties can confer subject-matter jurisdiction upon a federal court. Thus, the consent of the parties is irrelevant, California v. LaRue, 409 U.S. 109 (1972), principles of estoppel do not apply, American Fire & Casualty Co. v. Finn, 341 U.S. 6, 17-18 (1951), and a party does not waive the requirement by failing to challenge jurisdiction early in the proceedings. Similarly, a court, including an appellate court, will raise lack of

> subject-matter jurisdiction on its own motion. "[T]he rule, springing from the nature and limits of the judicial power of the United States is inflexible and without exception, which requires this court, of its own motion, to deny its jurisdiction, and, in the exercise of its appellate power, that of all other courts of the United States, in all cases where such jurisdiction does not affirmatively appear in the record." Mansfield, C. & L. M. R. Co. v. Swan, 111 U.S. 379, 382 (1884).

456 U.S. at 702 (footnote omitted).

Insurance Corp. of Ireland is explicit and "without exception" that subject matter jurisdiction cannot be waived by the parties. If a lack subject matter jurisdiction appears for the first time in this Court, then jurisdiction not only in this Court but also the court of appeals and the district court must be denied. See also, Fed. R. Civ. P. 12(h)("Whenever it appears by suggestion of the parties or otherwise that the court lacks jurisdiction of the subject matter, the court shall dismiss the action). Even where the defendant has himself removed the case from state to federal court, claiming jurisdiction based on diversity, and loses on the merits, he may raise a lack of diversity jurisdiction. See, American Fire & Casualty Co. v. Finn, 341 U.S. 6, 16-19 (1950). In such a circumstance, the correct procedure is for this Court to reverse the judgment and remand with instructions to have the case dismissed:

> Usually, where a court has no jurisdictions [sic] of a case, the correct practice is to dismiss the suit, but a different rule necessarily prevails in an appellate court in cases where

> the subordinate court was without jurisdiction and has given judgment or decree for the plaintiff, or improperly decreed affirmative relief to a claimant. In such a case, the judgment or decree in the court below must be reversed, else the party which prevailed there would have the benefit of such judgment or decree, though rendered by a court which had no authority to hear and determine the matter in controversy.

Mansfield, 111 U.S. at 385 (quoting of United States v. Huckabee, 16 Wall. 414, 435 (1872)).

Certiorari jurisdiction is warranted to determine whether the judgment of the district court should be reversed and the case dismissed for lack of subject matter jurisdiction.

## III.

### The Decision Of The Court Of Appeals Is Contrary To This Court's Subsequent Clarification Of § 10(b) of the Exchange Act

One of the two decisive issues on the merits below was whether GFL had a duty under § 10(b) of the Exchange Act, 15 U.S.C. § 78(j)(b), to disclose to Colkitt its intention to short sell the EquiMed and National Medical stock at the time it entered into the exchangeable notes – and its subsequent admitted short sales of those shares prior to each exchange demand. The court of appeals held that there is no disclosure obligation because the short sales did not result in tainted market prices for the EquiMed and National Medical stock.

In The Warf (Holdings) Ltd. v. United Int'l Holdings, Inc., which was decided after appellate briefing and was not considered by the court of appeals in rendering its decision, this Court clarified the disclosure obligations under § 10(b) in such cases. The defendant in that case argued that it had no duty to disclose its secret intention not to honor the option contract because that intention "does not 'relate to the value of a security purchase or the consideration paid.'" Id. 121 S. Ct. at 1781-82 (citation omitted). The Court began its analysis of the disclosure duty by explaining that courts must distinguish between the two potential securities involved in the § 10(b) claim – the underlying stock versus the future option itself to purchase the stock. The Court observed that this is consistent with the Exchange Act itself, which defines "security" to include both "'any . . . option . . . on any security' and 'any . . . right to . . . purchase' stock." Id. at 1780 (quoting 15 U.S.C. § 78c(a)(10) and citing Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 751 (1975)("holders of . . . options, and other contractual rights or duties to purchase . . . securities" are "'purchasers' . . . of securities for purposes of Rule 10b-5")).

Having identified the security at issue in the § 10(b) claim as the option itself rather than the underlying stock, the unanimous Court rejected the defendant's argument that it had no obligation to disclose information that did not impact the value of the underlying stock:

> But even were it the case that the Act covers only misrepresentations likely to affect the value of securities, Warf's secret reservation was such a misrepresentation. To sell an option while secretly intending not to permit the option's exercise is misleading, because a buyer normally presumes good faith. Cf., e.g.,

> Restatement (Second) of Torts § 530, Comment c (1976)("Since a promise necessarily carries with it the implied assertion of an intention to perform [,] it follows that a promise made without such an intention is fraudulent."). For similar reasons, the secret reservation misled United about the option's value. Since Warf did not intend to honor the option, the option was, unbeknownst to United, valueless.

Id. at 1782.

The court of appeals below did not consider The Warf in holding that GFL had no obligation to disclose the short sales to Colkitt. Consequently, the court of appeals opinion fails to distinguish between the two different securities underlying Colkitt's § 10(b) claims - the EquiMed and National Medical stocks versus the exchangeable notes themselves (the option). Most importantly, the court of appeals opinion fails to consider Colkitt's claim that GFL's failure to disclose the short sales misled Colkitt as to the value of the option (the exchangeable notes) rather than the underlying stocks.

Like the option contract in The Warf, there is no dispute in this case that the exchangeable notes are "securities" under the Exchange Act because they are option contracts to purchase securities in the future. The Warf, 121 S. Ct. at 1780. And like the option contract in The Warf, there can be little dispute that Colkitt was mislead as to the value of the notes by GFL's failure to disclose that it was short selling the stocks and depressing share prices, making the notes more costly to Colkitt by forcing him to sell additional shares to retire the same amount of debt. Indeed, the court of appeals ruled that Colkitt created a genuine issue

of material fact that GFL's undisclosed short sales depressed share prices by 18.5% for EquiMed and 17.5% for National Medical just prior to GFL's exchange demands. 272 F.3d at 206 n.6. The effect of GFL's undisclosed short sales was that, unbeknownst to Colkitt, he would be forced to pay GFL between 17.5% and 18.5% in additional shares to retire the same amount of debt. GFL thus reaped increased profits under the notes, extracting from Colkitt 27,882 more shares of EquiMed and 11,658 more shares of National Medical than GFL would have been entitled to receive without the undisclosed short selling. Under The Warf, GFL did have a duty to disclose its short sales to Colkitt.[1]

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[1] As a possible alternate ground for decision, the court of appeals suggested that Colkitt failed to present evidence that GFL intended to engage in the short sales at the time of the notes. App. B at 43a. That simply is not accurate and, even if it were, it does not end the analysis. Colkitt pointed to two pieces of evidence. The first was GFL's own affidavit, which states as follows:

> The price of each exchanged share of stock [under the notes] was "locked in" pursuant to the aforementioned formula as of the date of the Exchange Notice. GFL therefore assumed the risk associated with a subsequent price decrease in the subject stock. The additional time delay which resulted from the aforementioned restrictive legends exacerbated this risk . . . . This delay required GFL to engage in a short selling hedge strategy to minimize the risk.
>
> It is GFL's ***practice*** to review each component of its portfolio on a regular basis. In addition to the aforementioned hedge strategy, **GFL may at times sell a stock short if market conditions warrant and GFL has the right to convert shares but**

> **does not then possess "long" shares its portfolio to sell. Hence, rather than undertake numerous, small exchanges, GFL also took a limited short position in [National Medical] and EquiMed in certain instances** when it did not hold the stock long, but price and daily volume nevertheless presented favorable conditions for a limited sale of the stock.

(A copy of the Stout Affidavit is reproduced in App. F at 116a, Stout Aff. at ¶¶ 14-15)(emphasis added)). This affidavit creates a genuine issue of fact (if not fully establishes a party admission) that GFL's preexisting "practice" was to short sell stocks underlying its exchangeable notes. The second piece of evidence Colkitt pointed to, which confirms GFL's "practice", was a 1997 SEC decision against GFL's sister fund in which the SEC found that of 90 similar convertible stock transactions, GFL's sister fund had short sold the underlying securities in 62 of them. In re: GFL Ultra Fund Ltd., 64 S.E.C. Docket 1956, 1997 WL 330419 *2 (June 19, 1997).

However, even if GFL had no intention to short sell the stocks at the time it entered into the exchange notes, GFL was under a duty to disclose the short sales prior to each exchange demand it gave to Colkitt. The transaction was not completed when the notes were entered. The notes actually gave GFL the right to engage in a series of future transactions in which it could demand that Colkitt sell stock in exchange for retiring debt in amounts no less than $100,000 per transaction. (A copy of the Note relating to the EquiMed shares is reproduced in App. G at 128a, Note at § 2.1). Three months after the notes were entered, GFL gave Colkitt the first of three different exchange demands for EquiMed stock; and GFL gave Colkitt the first of six different exchange demands for National Medical stock four months after the notes were entered. App. B at 8a. GFL was under an obligation each time it demanded shares and created a new stock purchase transaction to disclose the existence of the short sales so as to make

Hence, summary judgment against Colkitt should have been reversed by the court of appeals, not affirmed.[2] Certiorari

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the exchange demands themselves (which contained new representations about market price) not misleading. See In Re Craftmatic Sec. Lit, 890 F.2d 628 (3d Cir. 1989).

The court of appeals held correctly that Colkitt need not prove reliance and damages to establish his affirmative defenses under § 10(b) and § 29(b), only his counterclaims. App. B at 28a-30a, Panel Op. fn. 6. Colkitt did, however, create genuine issues as to both, as well as scienter.

[2] The Warf also demonstrates why § 29(b) applies to this case and voids the notes. The court of appeals held that § 29(b) voids only contracts made or performed in violation of a provision of the Exchange Act. App. B at 21a. Colkitt does not dispute this proposition. The court of appeals went on to hold, however, that § 29(b) does not render the exchangeable notes in this case void because "GFL's *short sales* are completely independent of the parties' respective obligations under the terms of the notes . . . ." Id. (emphasis added). This holding is contrary to The Warf because it fails to distinguish between the two securities at issue in this case and Colkitt's independent market manipulation and securities fraud claims. Colkitt's claim that the notes violated § 10(b) because they failed to disclose the short sales was not even considered by the court of appeals in reaching this conclusion. If Colkitt proves his securities fraud claim that GFL violated § 10(b) by failing to disclose the short trades, the notes must, by definition, be void under § 29(b). This Court explained in The Warf that Rule 10b-5 forbids the use in connection with the purchase or sale of a security of a "omission of a material fact necessary in order to make the statements made . . . not misleading." The Warf, 121 S. Ct. at 1780 (quoting 17 C.F.R. § 240.10b-5). Using the language of § 29(b), exchangeable notes containing omissions of material fact entered in violation Rule of 10b-5 and § 10(b) would have been

jurisdiction is warranted to correct this error and maintain the uniformity of the Third Circuit's decisions with controlling Supreme Court precedent.

## CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted,

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"made in violation" of the Exchange Act, and each subsequent exchange demand would have been a "performance of which involved the violation of" the Exchange Act. 15 U.S.C. § 78cc(b). See also Mills v. Electric Auto-Lite Co., 396 U.S. 375, 386-87 (1970)(under § 29(b) "the guilty party is precluded from enforcing the contract against an unwilling innocent party"); Sundstrand Corp. v. Sun Chemical Corp., 553 F.2d 1033, 1051 (7th Cir.), cert. denied, 434 U.S. 875 (1977)(securities fraud in violation of § 10(b) voids and renders unenforceable option contract under § 29(b)); Grove v. First Nat'l. Bank of Herminie, 489 F.2d 512 (3d Cir. 1974)(per curiam)(lender that violates Exchange Act regulation barred by § 29(b) from recovering deficiency on loan).

## APPENDIX A

## UNITED STATES COURT OF APPEALS
## FOR THE THIRD CIRCUIT

**No. 00-2428**
**D.C. Civ. No. 97-cv-00526**

**[Filed December 21, 2001]**

GFL ADVANTAGE FUND, LTD.,)
a British Virgin Islands Corporation,)
)
v. )
)
DOUGLAS R. COLKITT )
Douglas Colkitt, Appellant. )
)

PRESENT:
BECKER, Chief Judge
SLOVITER, SCIRICA, NYGAARD,
ALITO, ROTH, McKEE, BARRY,
AMBRO, FUENTES, GREENBERG*
and COWEN*, Circuit Judges,

**SUR PETITION FOR REHEARING**

*As to panel rehearing only.

The petition for rehearing filed by appellant in the above-entitled case having been submitted to the judges who participated in the decision of this Court and to all the other available circuit judges of the circuit in regular active service, and no judge who concurred in the decision having asked for rehearing, and a majority of the circuit judges of the circuit in regular service not having voted for rehearing, the petition for rehearing by the panel and the Court en banc, is denied.

BY THE COURT,

/s/_____
Circuit Judge

Dated: December 21, 2001

## APPENDIX B

## UNITED STATES COURT OF APPEALS
## FOR THE THIRD CIRCUIT

**No. 00-2428**

**[Filed November 16, 2001]**

GFL ADVANTAGE FUND, LTD.,)
a British Virgin Islands Corporation,)
)
v. )
)
DOUGLAS R. COLKITT )
Douglas Colkitt, Appellant. )
)

On Appeal from the
United States District Court
for the Middle District of Pennsylvania
No. 4:CV-97-0526
District Judge: Honorable James F. McClure, Jr.

**JUDGES:**
Before: SCIRICA, GREENBERG and COWEN, Circuit Judges.

**OPINION BY:**
GREENBERG

## OPINION

This matter comes on before this court on defendant Douglas R. Colkitt's appeal from the district court's order for summary judgment in favor of plaintiff GFL Advantage Fund, Ltd. against Colkitt entered on April 25, 2000, and on appeal from an order entered on July 17, 2000, denying reconsideration of the April 25 order. For the reasons stated herein, we will affirm the orders of the district court.

## I. BACKGROUND

### A. FACTUAL HISTORY

Douglas Colkitt, who earned both his medical degree and MBA from the University of Pennsylvania in 1979, is the founder and majority shareholder of two small capitalization medical services businesses -- EquiMed, Inc. ("EquiMed") and National Medical Financial Services Corporation ("National Medical"). As of February 1996, Colkitt held 20,783,633 (73%) of EquiMed's 28,589,717 outstanding shares of common stock, and as of May 1996, he owned 2.8 million (38%) of National Medical's 7,426,844 outstanding shares of common stock. *See GFL Advantage Fund, Ltd. v. Colkitt*, No. 4:CV-97-0526, Memorandum and Order at 4 (M.D. Pa. July 17, 2000).

Beginning in 1996, Colkitt sought financing to pursue various business ventures unrelated to EquiMed and National Medical. After unsuccessfully attempting to secure financing

from traditional commercial lending institutions, Colkitt contacted alternative lenders that might be willing to structure "convertible or exchange transactions," whereby Colkitt would be able immediately to convert his vast stockholdings into cash. In particular, Colkitt endeavored to borrow money by pledging his common stock as collateral and providing the lender with the right to convert or exchange the debt for the shares pledged by Colkitt.

In the spring of 1996, Colkitt's broker identified GFL Advantage Fund, Ltd. ("GFL") as a possible lender, and on May 24, 1996, Colkitt obtained a loan of $ 3,000,000 from GFL. Under the terms of the note ("National Medical note"), GFL had the right after 30 days of the date of the note to exchange up to $1.5 million of its outstanding principal for shares of National Medical stock held by Colkitt at an exchange rate of 82% of the average market price. GFL could exchange the remainder of the unpaid balance for shares of National Medical 60 days after the date of the note. The average market price was computed by taking the average of the stock's closing prices for the five days immediately prior to the exchange request. In essence, the note gave GFL the right to require Colkitt to repay the loan with National Medical stock valued at a discount of 18% of the five-day average closing price, thus giving GFL an immediate paper profit as it would receive stock with a premium value to repay a debt of a lesser amount.

Several months later on August 5, 1996, Colkitt entered into a similar transaction with GFL for a $10,000,000 loan. The structure of the second note ("EquiMed note") was akin to that of the National Medical note, except the parties agreed that GFL could convert the debt into shares of

Colkitt's other business, EquiMed, Inc., at an exchange rate of 83% of the average market price. In addition, GFL could convert up to $5 million of the outstanding principal after 60 days of the date of the note and could convert the balance of the principal 30 days thereafter.

Nearly four months after issuing the initial $3,000,000 loan to Colkitt, GFL made its first of six exchange demands for National Medical stock. On September 13, 1996, GFL exchanged $250,000 of debt for 34,130 shares of National Medical stock at the average market price of $9.20 and an exchange or conversion price of $7.32. On September 19, 1996, GFL exchanged $135,000 of loan principal for 18,726 shares at an average market price of $9.075 and a conversion price of $7.21. On October 10, 1996, GFL converted $257,000 of debt into 47,081 shares at an average closing price of $6.925 and a conversion price of $5.46. On December 5, 1996, GFL exchanged $100,000 of unpaid principal for 14,845 shares at an average market price of $8.725 and an exchange price of $6.74. On December 19, 1996, GFL converted $200,000 of debt into 34,588 shares at an average market price of $7.525 and a conversion price of $5.78. Finally, on January 7, 1997, GFL demanded an exchange of $545,000 of loan principal for 100,223 shares, but the request was withdrawn after Colkitt dishonored GFL's earlier exchange demand for EquiMed stock.

GFL waited until November 1996, more than 3 months after the date of the EquiMed note, before making its first exchange demand for EquiMed shares. On November 27, 1996, GFL demanded that Colkitt convert $560,000 in outstanding principal into EquiMed stock. With a five-day average closing price of $4.50, GFL received 150,555 shares

of EquiMed at an exchange rate price of $3.72. GFL's next exchange demand for EquiMed stock occurred on January 3, 1997, when GFL sought to convert $1,430,000 in unpaid principal, but Colkitt dishonored the request.

Unknown to Colkitt at the time, and on the same day in September 1996 as GFL's first exchange demand for National Medical stock, GFL began short selling National Medical stock. As we have explained:

> Short selling is accomplished by selling stock which the investor does not yet own; normally this is done by borrowing shares from a broker at an agreed upon fee or rate of interest . . . . The short seller is obligated, however, to buy an equivalent number of shares in order to return the borrowed shares . . . . Herein lies the short seller's potential for profit: if the price of stock declines after the short sale, he does not need all the funds to make this covering purchase; the short seller then pockets the difference. On the other hand, there is no limit to the short seller's potential loss: if the price of the stock rises, so too does the short seller's loss, and since there is no cap to a stock's price, there is no limitation on the short seller's risk.

*Zlotnick v. Tie Communications*, 836 F.2d 818, 820 (3d Cir. 1988). *See also* 17 C.F.R. §240.3b-3 (defining short sale as "any sale of a security which the seller does not own or any sale which is consummated by the delivery of a security borrowed by, or for the account of, the seller"); Black's Law Dictionary 1339 (7th ed. 1999) (defining short sale as the "sale of a security that the seller does not own or has not contracted for at the time of sale, and that the seller must borrow to make delivery"). In other words, short sellers

are betting that the stock price will decline between the time they sell the borrowed stock and the time they must "cover," i.e., purchase replacement shares to repay the borrowed stock. Short selling, which is closely regulated, *see*, *e.g.*, 17 C.F.R. §240.10a-1, is a legitimate trading strategy for stocks that traders believe are overvalued.

GFL's first short sale of National Medical stock occurred on September 13, 1996, when it sold 32,500 shares at a price of $10.00 per share. On September 16, 1996, GFL sold short 15,000 shares of National Medical at $9.13 per share. On September 17, 1996, GFL sold short 5,000 shares at $9.25 per share. On October 11, 1996, GFL sold short 3,000 shares at $8.25 per share. Finally, on October 14, 1996, GFL sold short 7,000 shares of National Medical at $8.25 per share. GFL sold short a total of 62,500 shares of National Medical stock over a one-month period.

GFL also sold EquiMed shares short. On November 8, 1996, GFL sold short a total of18,400 shares of EquiMed -- 10,000 shares at $5.50 per share and 8,400 shares at $5.48 per share. On November 11, 1996, GFL sold short 32,500 shares at $5.38 per share. On November 12, 1996, GFL sold short 16,000 shares at $5.25 per share. On November 14, 1996, GFL sold short 8,500 shares at $5.25 per share. Finally, on November 22, 1996, GFL sold short 3,300 shares of EquiMed stock at $5.00 per share. Over this two-week period in November 1996, GFL sold short a total of 78,700 shares of EquiMed stock.

GFL explains that it engaged in short sales of National Medical and EquiMed stock as a hedging strategy against "delivery risk." Under the terms of the notes, the exchange

price was based on the average closing price during the five trading days preceding the exchange request. Consequently, the exchange price was locked in on the date of the exchange request, thus shifting onto GFL the risk that the stock's price would drop more than the 17% or 18% discount. In other words, "if the stock price dropped more than the agreed-upon discount before GFL was able to sell the exchanged shares, GFL would be in a loss position." Br. of Appellee at 7. GFL claims it sold short to protect itself in the event that the price of the stock declined further after GFL made the exchange request but before GFL was able to sell the shares.

The theory of Colkitt's case, however, is that GFL sold National Medical and EquiMed shares short in an effort to depress the prices of the stocks. Indeed, Colkitt contends that the market price of National Medical dropped 17.5% between GFL's first and last short sales of National Medical stock, and that the market price of EquiMed declined by 18.5% between GFL's first short sale of EquiMed stock and GFL's first exchange demand.[1] Colkitt argues that GFL purposely depressed the stock prices so that Colkitt would be

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[1] Inexplicably, Colkitt measures the price decline of EquiMed stock during the period between GFL's first short sale on November 8, 1996, and GFL's first exchange demand on November 27, 1996, rather than between GFL's first short sale on November 8, 1996, and its last short sale on November 22, 1996. As GFL points out, however, if the price decline of EquiMed stock is measured during the period between GFL's first and last short sales, EquiMed's price drop would be approximately 2. *See* Br. of Appellee at 36. More specifically, the price of EquiMed on the day of the first short trade on November 8 was $5.25 per share, whereas the price on the day of the last short sale on November 22 was $5.13. *See id.* at 36 n.13. This $.12 drop represents only a 2.3 decrease.

forced to exchange more shares to retire the same amount of debt. He asserts that GFL was able to obtain an additional 27,882 shares of EquiMed and an additional 11,658 shares of National Medical due to the respective declines in the stocks' prices.

As noted above, Colkitt refused to honor GFL's exchange request for EquiMed shares on January 3, 1997. Instead, Colkitt notified GFL in December 1996 and early January 1997 that he intended to prepay all unpaid principal and interest in cash. Colkitt contends that GFL improperly rejected his request to prepay the unpaid balance, even though the notes contemplated such prepayment. GFL responds that it did not reject outright Colkitt's offer to prepay, but rather refused to allow Colkitt to dictate the terms of any prepayment and disagreed with Colkitt about the amounts due. GFL admits that it does not believe that Colkitt had a right to prepay, but insists that it "accepted Colkitt's offer to prepay whatever amount Colkitt believed was then due, reserving for itself the right to contest the disputed balance." Br. of Appellee at 13. GFL claims that Colkitt neither responded to its overtures nor attempted to prepay or pay any amounts to GFL.

## B. PROCEDURAL HISTORY

On April 4, 1997, GFL filed a complaint against Colkitt alleging breach of his obligations on the National Medical and EquiMed notes. On June 6, 1997, Colkitt filed an answer, affirmative defenses, and six counterclaims. The affirmative defenses and counterclaims alleged, *inter alia*, that GFL engaged in securities fraud and market manipulation in violation of various federal and state securities laws by

temporarily depressing the prices of National Medical and EquiMed stock through its concentrated short sales. Colkitt claimed that GFL engaged in the scheme so that it could exchange debt for shares at an artificially low price and earn enormous windfall profits when prices returned to their normal levels. On March 31, 1998, the district court adopted a magistrate judge's recommendations that Colkitt's counterclaims be dismissed. The district court dismissed one counterclaim with prejudice and the balance without prejudice.[2] On April 20, 1998, Colkitt filed amended counterclaims in an effort to cure the deficiencies of the original counterclaims, but on February 2, 1999, the district court again dismissed Colkitt's inadequately pled counterclaims without prejudice for lack of specificity.

On April 25, 2000, the district court granted summary judgment in favor of GFL based largely on the reasoning of *In re Olympia Brewing Co. Securities Litigation,* 613 F. Supp. 1286 (N.D. Ill. 1985). The court concluded that, because short selling is not an unlawful trading practice, it would not draw the inference that GFL manipulated the

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[2] The Court dismissed counterclaims I (Section 10(b) of the Security Exchange Act of 1934 and Rule 10b-5 under the Act), III (Section 29 of the Securities Exchange Act of 1934), IV (Pennsylvania Securities Act), and V (common law fraud) without prejudice for lack of specificity. The court dismissed counterclaim II (Section 17 of the Securities Act of 1933) with prejudice, subject to reinstatement in the event that we recognize a private right of action under Section 17 of the Securities Act of 1933, 15 U.S.C. §77q(a). The court dismissed counterclaim count VI (unjust enrichment) without prejudice because the equitable remedy of unjust enrichment is not available when a contract exists between the parties. Although the court initially dismissed count VI with prejudice, the court concluded on reconsideration that the order was in error and changed the dismissal to a dismissal without prejudice.

market price of EquiMed and National Medical stocks simply because GFL engaged in substantial short selling of the stocks. The court also determined that Colkitt failed to present evidence that GFL's short sales had an appreciable effect on the prices of the stocks. Finally, the court concluded that even if the short sales did depress prices, Colkitt failed to show that "the declines in price are attributable to false information injected into the market by the short sales and not to information otherwise available to the market." *GFL Advantage Fund, Ltd. v. Colkitt*, No. 4:CV-97-0526, Memorandum and Order at 22 (M.D. Pa. Apr. 25, 2000).

On July 17, 2000, the district court denied Colkitt's motion for reconsideration and entered final judgment in favor of GFL. The court clarified its earlier ruling on GFL's motion for summary judgment, explaining that the evidence of GFL's short sales alone was insufficient to establish Colkitt's claims of securities fraud and market manipulation because selling stocks short is lawful. The court declared that "there must be some circumstances beyond the mere occurrence of short sales to suggest that the short sales were part of a scheme to manipulate the market," which Colkitt failed to proffer. *GFL Advantage Fund, Ltd. v. Colkitt*, No. 4:CV-97-0526, Memorandum and Order at 14 (M.D. Pa. July 17, 2000). The court then proceeded to reject Colkitt's argument that numerous inferences that he believed should be drawn from the factual record created genuine issues of material fact that precluded summary judgment. The court refused to accept any of Colkitt's proffered inferences -- each of which Colkitt has raised on appeal -- and reaffirmed its decision that GFL was entitled to summary judgment as a matter of law.

## II. JURISDICTION AND STANDARD OF REVIEW

### A. JURISDICTION

The district court had subject matter jurisdiction over GFL's breach of contract action pursuant to 28 U.S.C. §1332 based upon diversity of the parties and the amount in controversy. The district court entered final judgment in this case on July 17, 2000, and appellant filed a timely notice of appeal on August 15, 2000. Therefore, we have jurisdiction pursuant to 28 U.S.C. §1291.[3]

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[3] As noted above, the district court twice dismissed certain of Colkitt's counterclaims without prejudice for lack of specificity. In some circumstances, such a dismissal could deprive us of appellate jurisdiction as "ordinarily we do not have jurisdiction under 28 U.S.C. §1291 of an appeal from an order partially adjudicating a case when an appellant has asserted a claim in district court which it has withdrawn or dismissed without prejudice." *Erie County Retirees Ass'n v. County of Erie,* 220 F.3d 193, 201 (3d Cir. 2000). Our case law, however, allows us to exercise appellate jurisdiction under 28 U.S.C. §1291 when the district court has divested itself of the case entirely. *See id.* at 202. Here, although the district court's orders dismissed Colkitt's counterclaims without prejudice, the court's summary judgment order effectively barred Colkitt from re-filing them, for the court concluded that Colkitt's affirmative defenses -- which were identical to his counterclaims -- failed as a matter of law. Consequently, the court's order granting summary judgment in favor of GFL terminated the suit so far as the court was concerned. *See Trent v. Dial Med. of Fla., Inc.,* 33 F.3d 217, 220 (3d Cir. 1994) ("Even dismissals without prejudice have been held to be final and appealable if they end [the] suit so far as the District Court was concerned . . . . ' ") (citation omitted). Therefore, we have jurisdiction over this appeal.

B. STANDARD OF REVIEW

We review the district court's grant of summary judgment *de novo* and apply the same standard as the district court applied in the first instance. *See Lucent Info. Mgmt., Inc. v. Lucent Tech., Inc.*, 186 F.3d 311, 315 (3d Cir. 1999). We may affirm summary judgment in favor of GFL only if, after drawing all reasonable inferences from the record in the light most favorable to Colkitt, "there is no genuine issue as to any material fact" and GFL is "entitled to a judgment as a matter of law."Fed. R. Civ. P. 56(c). As the nonmoving party, Colkitt must create a genuine issue of material fact by presenting sufficient evidence to permit a jury to find in his favor. *See Anderson v. Liberty Lobby, Inc.*, 477 U.S. 242, 248, 106 S. Ct. 2505, 2510, 91 L. Ed. 2d 202 (1986). To defeat summary judgment, he "cannot rest simply on the allegations in the pleadings,"but "must rely on affidavits, depositions, answers to interrogatories, or admissions on file." *Bhatla v. U.S. Capital Corp.*, 990 F.2d 780, 787 (3d Cir. 1993). Therefore, it will be appropriate to affirm summary judgment for GFL if we conclude that there is insufficient evidence for a reasonable jury to return a verdict for Colkitt.

## III. DISCUSSION

A. RESCISSION OF THE NOTES PURSUANT TO SECTION 29

Colkitt contends that the National Medical and EquiMed notes are unenforceable by reason of Section 29 of the Securities Exchange Act of 1934 ("Exchange Act") because GFL violated the anti-fraud provisions under Section

10(b) of the Exchange Act and Rule 10b-5 promulgated thereunder. Section 29(b) provides in relevant part that:

> Every contract made in violation of any provision of this chapter or of any rule or regulation thereunder, . . . [or] the performance of which involves the violation of, or the continuance of any relationship or practice in violation of, any provision of this chapter or any rule or regulation thereunder, shall be void.

15 U.S.C. §78cc(b) (emphasis added). Colkitt argues that GFL violated Section 10(b) and Rule 10b-5 when it engaged in market manipulation by short selling National Medical and EquiMed stock in an effort to depress the share prices, and when it engaged in fraudulent deception by concealing its plan to short sell National Medical and EquiMed stock. See Br. of Appellant at 24. Colkitt asserts that the notes are void and unenforceable under Section 29(b) because the notes were "made in violation of" Section 10(b) and Rule 10b-5 insofar as (1) they were part of GFL's scheme to manipulate the market prices of National Medical and EquiMed stock and (2) they contain omissions of material fact about GFL's short selling strategy. *See* Reply Br. of Appellant at 19.

GFL argues that Colkitt's Section 29(b) affirmative defense fails for two reasons. First, Section 29(b) is a remedial provision that is triggered only when another section of the Exchange Act has been violated. As addressed below, GFL maintains that it did not engage in either market manipulation or securities fraud in violation of Section 10(b), and therefore, there is no underlying offense to trigger Section 29(b). *See* infra pp. 17-36. Second, GFL contends

that Colkitt fails to state a proper Section 29(b) defense inasmuch as Colkitt alleges that it is GFL's short selling, not the National Medical and EquiMed notes, that is unlawful. GFL argues that only "unlawful contracts," not "unlawful transactions" executed pursuant to lawful contracts, may be rescinded under Section 29(b).

We deal with GFL's second contention first, which is supported by the limited body of case law on the point. For instance, in *Slomiak v. Bear Stearns & Co.*, 597 F. Supp. 676, 677 (S.D.N.Y. 1984), plaintiff opened a margin account and a repurchase account with defendant Bear Stearns. He purchased millions of dollars of government bonds in his margin account -- less than 10% with cash and the remainder with loans by Bear Stearns. *See id.* When plaintiff was notified of a margin call on his account and failed to muster the $155,000 in additional margin demanded, Bear Stearns liquidated the government bonds in plaintiff's account. *See id.* Plaintiff alleged that Bear Stearns violated Section 10(b) and Rule 10b-16 by failing to provide him at the time he opened his accounts with a written statement explaining the terms under which Bear Stearns would extend him credit. *See id.* Based on these alleged violations, plaintiff sought to rescind all of his bond transactions pursuant to Section 29(b). *See id.* at 681. The court concluded that plaintiff could not rescind the transactions, explaining:

> The complaint alleges that Bear Stearns failed to send plaintiff a written credit disclosure statement in violation of Rule 10b-16 at the time he opened his accounts; it does not allege that the customer agreements establishing his margin and repurchase accounts at Bear

> Stearns were themselves unlawful . . . . 'Under §29 of the Exchange Act, only unlawful contracts may be rescinded, not unlawful transactions made pursuant to lawful contracts.'

*Id.* at 681-82 (quoting *Zerman v. Jacobs,* 510 F. Supp. 132, 135 (S.D.N.Y. 1981), aff'd, 672 F.2d 901 (2d Cir. 1981) (table)). Because Bear Stearns's alleged violation of Rule 10b-16 was "clearly collateral to the contract agreement governing the account," the court determined that the firm's failure to provide the written statement to plaintiff did "not justify rescission of the account agreement itself or the transactions undertaken pursuant to that agreement." *Id.* at 682-83.

In *Drasner v. Thomson McKinnon Securities, Inc.*, 433 F. Supp. 485, 488-89 (S.D.N.Y. 1977), plaintiffs maintained margin accounts with defendant Thomson McKinnon Securities between 1973 and 1975. Plaintiffs began selling naked options in 1974 and profited handsomely off the transactions until 1975, when the market began spiking upward. *See id.* Between January and May 1975, plaintiffs incurred substantial losses on their options until Thomson McKinnon finally closed their accounts and liquidated their collateral. *See id.* at 489. Plaintiffs sought to rescind the options contracts pursuant to Section 29(b) because Thomson McKinnon allegedly violated Regulation T by failing to direct plaintiffs to deposit the required amount of initial margin in their accounts. *See id.* The court rejected plaintiffs' claim, stating that Section 29(b) "only renders void those contracts which by their terms violate the Act or the rules and regulations thereunder . . . for it is only such contracts which are 'made in violation of,' or 'the performance of which

involves the violation of' the statute and the rules and regulations thereunder." *Id.* at 501-02. The court explained that even if Thomson McKinnon had violated Regulation T, Section 29(b) was inapplicable because the options contracts that plaintiffs sought to rescind were governed by a valid, lawful contract whose terms did not violate the Exchange Act or any regulations promulgated thereunder. *See id.* at 502.

Colkitt responds to GFL's argument by citing *Regional Properties, Inc. v. Financial and Real Estate Consulting Co.*, 678 F.2d 552, 560 (5th Cir. 1982), which challenges Drasner's narrow construction of Section 29(b). In *Regional Properties*, two real estate entrepreneurs brought suit against their broker and his firm, Financial and Real Estate Consulting Co. ("Financial"), alleging that the broker had violated Section 15(a)(1) of the Exchange Act by selling limited partnership interests for them without having registered with the SEC as a broker-dealer. *See id.* at 556. The entrepreneurs and their affiliated corporations sought to rescind their agreements with Financial pursuant to Section 29(b) in light of the broker's violations of Section 15(a)(1). *See id.* The court rejected Drasner's conclusion that Section 29(b) renders void only those contracts that "by their terms" violate the Exchange Act and instead interpreted Section 29(b) as "rendering voidable those contracts that are either illegal when made or as in fact performed." *Id.* at 560. The court concluded that rescission was proper because, although plaintiffs sought to avoid contracts that were "perfectly lawful on their face," the performance of the contracts by Financial nevertheless "resulted in a violation of the Act." *Id.* at 561. The court added: "That these contracts, under different circumstances, could have been performed without violating the Act is immaterial." *Id.*

Although the court of appeals in *Regional Properties* rescinded the contracts therein and explicitly rejected *Drasner*'s narrow reading of Section 29(b), its opinion is nevertheless consistent with the outcomes in *Drasner*, *Slomiak*, and *Zerman*. In particular, the violations of the Exchange Act alleged in *Drasner*, *Slomiak*, and *Zerman* were "collateral or tangential to the contract between the parties," whereas the violation alleged in *Regional Properties* was "inseparable from the performance of the contract" that plaintiffs were attempting to void. *Slomiak,* 597 F. Supp. at 682. The parties could -- and did -- perform the contracts at issue in *Drasner*, *Slomiak*, and *Zerman* without committing any violations of the Exchange Act, but the broker in *Regional Properties* could not carry out his obligations under the agreements without violating the Exchange Act, for performance of the agreements entailed selling partnership interests, which the broker lawfully could not do due to his failure to register as a broker-dealer.

The other two cases cited by Colkitt are also consistent with this analysis. In both cases, the courts voided loan agreements because the banks violated Regulation U, which governs the amount of money that a bank can lend for the purchase of registered securities. In *Grove v. First National Bank of Herminie,* 489 F.2d 512, 513 (3d Cir. 1974) (per curiam), bank employees failed to explain to plaintiff that under federal law, the bank "could lend only a certain percentage of the market value of stock to purchase registered securities."Concluding that the bank had violated Regulation U, we held that Section 29(b) precluded the bank from recovering a deficiency, "even if the borrower knowingly and intentionally deceives the bank as to the actual purposes of the loans." *Id.* at 516.

In *Stonehill v. Security National Bank,* 68 F.R.D. 24, 28 (S.D.N.Y. 1975), a bank sought to recover the outstanding balance on a loan, but the borrower claimed that the loan was void and unenforceable because the bank issued the loan in violation of Regulation U. The bank argued that even if the borrower's obligations were void due to the bank's alleged violation of Regulation U, it still could recover from the guarantor. *See id.* at 33. The court disagreed, holding that "if the principal obligation violates Regulation U, a guarantee of that obligation is void under §29(b) of the Exchange Act." *Id.* The court explained that "allowing a bank to recover on a guarantee even though the underlying loan violated Regulation U would encourage banks to extend credit in violation of the margin requirements." *Id.* at 34.

As with the violation of Section 15(a)(1) in *Regional Properties*, the violations of Regulation U in *Grove* and *Stonehill* were inseparable from the underlying agreements between the parties: the banks could not perform their obligations under the loan agreements (i.e., lend money to the borrowers so that they could purchase securities) without violating Regulation U. In fact, the loans were "made in violation of" the Exchange Act because a greater percentage of the loans was used to purchase securities than is allowed under Regulation U.

The same cannot be said for GFL's obligations under the National Medical and EquiMed notes in this case. GFL's allegedly unlawful short sales of National Medical and EquiMed stock were nothing more than "collateral or tangential" to the notes. Colkitt insists that performance of the contracts "involves a violation of" securities laws because "performance itself (exchange of shares and repayment of the

loan plus interest) . . . supports GFL's illegal short selling by giving GFL shares with which to cover the short sales." Br. of Appellant at 25 n.8. Despite the theory of Colkitt's case, however, GFL's short sales are completely independent of the parties' respective obligations under the terms of the notes -- namely, GFL's obligation to lend Colkitt a total of $13,000,000, and Colkitt's obligation to repay the loans at GFL's option with shares of National Medical and EquiMed stock. In the end, GFL's alleged unlawful activity (i.e., its short sales) is too attenuated from the parties' valid, lawful contracts (i.e., the National Medical and EquiMed notes) or GFL's performance thereunder. Therefore, we conclude that the notes were neither made nor performed in violation of any federal securities laws as is required for rescission under Section 29(b).[4]

## B. MARKET MANIPULATION

Colkitt argues that the district court erred in rejecting his affirmative defense that the notes are void pursuant to Section 29(b) due to GFL's alleged market manipulation, as there exist genuine issues of material fact regarding whether GFL's short sales constituted market manipulation in violation of Section 10(b) and Rule 10b-5. GFL argues, however, that Colkitt has not presented enough evidence to create triable

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[4] Notwithstanding our conclusions as to the scope of Section 29(b), we will discuss the market manipulation and securities fraud issues as our conclusions on them are critical to our disposition of Colkitt's appeal from the dismissal of his counterclaims. *See supra* note 3.

issues on any of the elements of market manipulation.[5]

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[5] GFL also insists that Colkitt cannot obtain reversal of summary judgment with respect to GFL's alleged manipulation of National Medical's price because Colkitt abandoned his market manipulation and securities fraud claims with respect to National Medical by conceding that GFL's short sales of National Medical stock did not violate any securities laws. *See* Br. of Appellee at 19-21. To support its contention, GFL quotes a passage from Colkitt's opposition to GFL's motion for summary judgment, which states that "the short selling of National Medical presents an interesting contrast to the short selling of EquiMed." *Id.* at 20 (quoting Colkitt's Brief in Opposition to Summary Judgment at 6 (App. 000837)). GFL claims that this statement, along with other unspecified passages in Colkitt's opposition and his motion for reconsideration, led the district court to limit its rulings to only the EquiMed note.

GFL's argument is without merit. A review of the district court's April 25, 2000 Memorandum reveals that the court addressed Colkitt's market manipulation and securities fraud claims as to both EquiMed and National Medical. Indeed, National Medical is mentioned throughout the district court's summary judgment and reconsideration rulings. There is no indication in the district court's rulings that Colkitt abandoned these claims or that the court limited its rulings to only the EquiMed note.

GFL also distorts the meaning of the above-quoted passage by taking it out of context. When Colkitt admitted that the short sales of National Medical differed in some respects to the short sales of EquiMed, he was referring only to GFL's contention that it engaged in the short sales as a hedging strategy. As will be explained in more detail below, *see* infra pp. 28-30, Colkitt's expert maintains that selling short prior to the five-day period before the exchange demand is not a legitimate hedging strategy, but instead an attempt to profit from declining stock prices. The expert insists that if GFL were only trying to hedge against a possible drop in price after the demand (so-called "delivery risk"), GFL could have eliminated that risk by selling short during the five-day period before the exchange demand -- in essence, locking in the sale price during the same period the average closing price would be calculated. Colkitt's statement was simply an "acknowledgment

1. Elements of Market Manipulation Under Section 10(b) and Rule 10b-5

As an initial matter, the parties disagree about the specific elements of market manipulation under Section 10(b) and Rule 10b-5. To complicate matters further, we seemed not to have addressed squarely what elements are required to establish a claim of market manipulation, particularly in the context of a Section 29(b) affirmative defense, and the case law from other courts of appeals and district courts on this issue provides limited guidance. Section 10(b) states in relevant part that "it shall be unlawful for any person . . . to use or employ, in connection with the purchase or sale of any security . . ., any manipulative or deceptive device or contrivance in contravention of such rules and regulations" promulgated by the SEC.15 U.S.C. §78j. Rule-10b-5 provides in relevant part that "it shall be unlawful for any person . . . to employ any device, scheme, or artifice to defraud." 17 C.F.R. §240.10b-5.

Noting that Section 10(b) outlaws but does not define a "manipulative or deceptive device or contrivance," Colkitt turns to Section 9(a) of the Exchange Act to determine the elements of the offense of market manipulation. Section 9(a) prohibits individuals from effecting "a series of transactions in any security registered on a national securities exchange . . .

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that, unlike the EquiMed shorts, the National Medical shorts, by their timing, could at least qualify as a hedge strategy" because they were made within the days immediately preceding GFL's exchange demands for National Medical stock. Reply Br. of Appellant at 5. This narrow admission cannot be construed as a complete waiver of his counterclaims and affirmative defenses with respect to the National Medical note.

creating actual or apparent active trading in such security, or raising or depressing the price of such security, for the purpose of inducing the purchase or sale of such security by others." 15 U.S.C. §78i(a)(2). Based on this passage and the Supreme Court's decision in *Aaron v. SEC,* 446 U.S. 680, 695, 100 S. Ct. 1945, 1955, 64 L. Ed. 2d 611 (1980), in which the Court recognized scienter as an element of a Section 10(b) claim, Colkitt maintains that summary judgment was improper because he created genuine issues with respect to each of the following elements of market manipulation: (1) GFL engaged in a series of transactions in the registered securities; (2) the purpose of GFL's short sales was to induce others to sell the securities; (3) GFL's short sales created "actual or apparent active trading" in the securities or depressed the prices of the securities; and (4) GFL acted with scienter.

GFL responds that Colkitt has mischaracterized the elements of market manipulation by applying an overly broad description of prohibited activities set forth under Section 9(a) and by ignoring the specific requirements of market manipulation that have evolved over time. GFL points out that market manipulation is "virtually a term of art when used in connection with the securities market. It connotes intentional and willful conduct designed to deceive or defraud investors by controlling or artificially affecting the price of securities." *Ernst & Ernst v. Hochfelder,* 425 U.S. 185, 199, 96 S. Ct. 1375, 1384, 47 L. Ed. 2d 668 (1976). GFL asserts that Colkitt disregards two necessary elements of a market manipulation claim -- that "GFL injected inaccurate information into the marketplace" and that GFL's conduct "affected the price" of National Medical and EquiMed stock. Br. of Appellee at 24.

The first disputed element is whether Colkitt must demonstrate that GFL injected inaccurate information into the marketplace or created a false impression of market activity. Like the district court, GFL relies on *Olympia Brewing*, 613 F. Supp. at 1292, in which the district court emphasized that the "essential element" of a market manipulation claim is the injection of "inaccurate information" into the market. GFL observes that even the cases cited by Colkitt "recognize that market manipulation requires an additional element, something beyond otherwise legal trading, which specifically injects false information into the market and/or creates an artificial demand for the underlying security." Br. of Appellee at 22 (emphasis added). Colkitt responds, however, that he is not required to present evidence that "GFL injected affirmative misinformation into the market," but only needs to demonstrate that "GFL's short trades were made for the undisclosed purpose of artificially depressing share prices." Reply Br. of Appellant at 9 (emphasis added).

Notwithstanding Colkitt's assertion to the contrary, the parties appear to be in accord on this point. Indeed, the difference between their positions seems to be one without distinction. Both GFL and Colkitt focus on the need to demonstrate that some action was taken to artificially depress or inflate prices, whether by purposely making false statements or by employing illegitimate, deceptive trading techniques that mislead investors about the price or demand for a stock.

To the extent that the parties' respective positions are at odds, however, GFL advances a sounder construction of a Section 10(b) market manipulation claim, for it is less vague than Colkitt's. The Supreme Court has indicated that market

manipulation "generally refers to practices, such as wash sales, matched orders, or rigged prices, that are intended to mislead investors by artificially affecting market activity." *Santa Fe Indus. v. Green,* 430 U.S. 462, 476, 97 S. Ct. 1292, 1302, 51 L. Ed. 2d 480 (1977). "The gravamen of manipulation is deception of investors into believing that prices at which they purchase and sell securities are determined by the natural interplay of supply and demand, not rigged by manipulators." *Gurary v. Winehouse,* 190 F.3d 37, 45 (2d Cir. 1999). In that vein, courts must distinguish between legitimate trading strategies intended to anticipate and respond to prevailing market forces and those designed to manipulate prices and deceive purchasers and sellers. Although Colkitt's construction properly reflects the aspiration of Section 10(b) of preventing market activities that artificially depress prices, it provides little guidance on which activities artificially affect prices and which activities legitimately impact prices.

Requiring a Section 10(b) plaintiff to establish that the alleged manipulator injected "inaccurate information" into the market or created a false impression of market activity cures this problem. Such a construction permits courts to differentiate between legitimate trading activities that permissibly may influence prices, such as short sales, and "ingenious devices that might be used to manipulate securities prices," *Santa Fe Indus.*, 430 U.S. at 477, 97 S. Ct. at 1303, such as wash sales and matched orders. As the court in *Olympia Brewing*, 613 F. Supp. at 1292, stated, "regardless of whether market manipulation is achieved through deceptive trading activities or deceptive statements as to the issuing corporation's value, it is clear that the essential element of the

claim is that inaccurate information is being injected into the marketplace."

The second disputed element is whether Colkitt must establish that GFL's allegedly manipulative conduct actually depressed the prices of National Medical and EquiMed stock. GFL argues that market manipulation in violation of Section 10(b) and Rule 10b-5 requires that the allegedly unlawful conduct impact a security's price. GFL cites three cases to support its position, but all three are unhelpful. First, although we stated in *Rosenberg v. Hano,* 121 F.2d 818, 821 (3d Cir. 1941) (footnote omitted), that "the party claiming injury must plead and prove some change in price, because of the prohibited acts," the case involved an alleged violation of Section 9, not Section 10(b) and Rule 10b-5. Second, the opinion in *United States v. Russo*, 74 F.3d 1383, 1394 (2d Cir. 1996), is not significant here because it only addressed the propriety of the portion of the district court's jury instruction on the scienter element that defined artificial price as the price level above the stock's actual value as determined by market forces. Third, the decision *In re Blech Securities Litigation,* 928 F. Supp. 1279, 1298 (S.D.N.Y. 1996) (citation omitted), directly contradicts GFL's position by stating that "the absence of allegations of market dominance and price movement are not fatal to" a claim of market manipulation, for although "these may be classic attributes of market manipulation, they are not requisites."

Colkitt's position is somewhat inconsistent on this point. On the one hand, he takes great pains to argue that GFL's short sales depressed the price of National Medical by 17.5% and the price of EquiMed by 18.5%. On the other hand, when confronted with evidence that the prices of the

stocks were on a sharp downward trend before and after GFL's short sales, thus raising serious doubts about the true reason for the declining prices, Colkitt reverses course and argues that he need not prove that GFL's alleged scheme was successful in depressing prices. Colkitt insists that he only must establish that GFL attempted to depress prices by selling shares short. To muddy the waters even more, Colkitt appears to make a concession that an impact on price must be established when he states in his reply brief: "A jury must also decide whether GFL's short trades had an affect [sic] on share prices." Reply Br. of Appellant at 11.

Despite his flip-flopping on the issue, Colkitt appears to be correct that he need not prove that GFL's manipulative conduct actually depressed prices. The Court of Appeals for the Fifth Circuit concluded in *Chemetron Corp. v. Business Funds, Inc.*, 718 F.2d 725, 728 (5th Cir. 1983), that Section 10(b), unlike Section 9(a), does not require that a plaintiff prove the allegedly unlawful activities had an effect on the price of the stock. Although any damages that Colkitt would be entitled to recover under his Section 10(b) and Rule 10b-5 counterclaim would be contingent on proving that GFL's conduct actually depressed prices, proof of price movement is not necessary to establish a violation of Section 10(b) and Rule 10b-5 and therefore is not necessary to support his assertion of an affirmative defense under Section 29(b).[6]

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[6] Although maintaining a private right of action under Section 10(b) requires a plaintiff to prove reliance and damages (usually reflected in the stock's price movement), Section 29(b) only requires a violation of Section 10(b), not the maintenance of a private suit under Section 10(b). Therefore, looking to the statutory language of the anti-fraud provision, we note that an individual violates Section 10(b) -- and therefore triggers Section

29(b) -- when he or she employs manipulative or deceptive devices in connection with the purchase or sale of securities. This situation is analogous to a government prosecution under Section 10(b), in which the government is not required to meet the normal standing requirements imposed on those asserting a private remedy, inasmuch as the government need not demonstrate that the defendant's conduct induced reliance by investors or affected the price of the security. *See, e.g., United States v. Haddy*, 134 F.3d 542, 549 (3d Cir. 1998) (holding that reliance is not an element of the crime of stock manipulation).

Even if we were to embrace the position of GFL and the district court that proof of an effect on price is necessary to establish a claim of market manipulation, the district court still erred in concluding that Colkitt failed to create a genuine issue of material fact with respect to price movement. As already noted, Colkitt claims that the price of National Medical dropped 17.5% and the price of EquiMed plummeted 18.5% during the period of GFL's short sales. The district court concluded, however, that these statistics are "not evidence that the value of the shares was affected by the short sales: the free fall began before the short sales and continued well after the short sales." *GFL Advantage Fund, Ltd. v. Colkitt,* No. 4:CV-97-0526, Memorandum and Order at 21 (M.D. Pa. July 17, 2000). The district court observed that the price of EquiMed declined steadily from $ 15.00 on February 1, 1996, to $2.4583 on January 2, 1998, including a dramatic drop of 27.6%, from $7.25 to $5.25, during the 24-day period immediately preceding GFL's short sales. *See id.* at 20-21. The court also noted that National Medical plummeted from $12.875 on May 1, 1996, to $0.4375 on January 2, 1998. *See GFL Advantage, Ltd. v. Colkitt,* No. 4:CV-97-0526, Memorandum and Order at 18 (M.D. Pa. Apr. 25, 2000). Based on these long-term, downward trends in the stocks' prices, the district court concluded that Colkitt could not prove that GFL's short sales had an effect on the price of either National Medical or EquiMed stock. Although the court was correct that other factors clearly were contributing to the slide in prices, it was not within the court's province to weigh the evidence as a finder of fact. Whether and how much GFL's alleged unlawful conduct contributed to the downturn in prices would have been issues for the jury if Colkitt's case had survived GFL's motion for summary judgment. Contrary to the district court's conclusion,

We are satisfied that, at bottom, neither party properly articulates the elements of market manipulation under Section 10(b) in the context of a Section 29(b) affirmative defense. Because we have not squarely addressed this issue, we must set forth the necessary elements for such a claim. In this regard, we conclude that to establish a Section 29(b) affirmative defense of market manipulation in violation of Section 10(b) and Rule 10b-5, Colkitt must present evidence that (1) in connection with the purchase or sale of securities, (2) GFL engaged in deceptive or manipulative conduct by injecting inaccurate information into the marketplace or creating a false impression of supply and demand for the security (3) for the purpose of artificially depressing or inflating the price of the security.

2. Evidence Supporting Colkitt's Claim of Market Manipulation:

Colkitt's affirmative defense based upon GFL's alleged market manipulation fails because he cannot demonstrate that GFL engaged in any deceptive or manipulative conduct by injecting false inaccurate information into the marketplace or creating a false impression of supply and demand for the stock. As the district court explained repeatedly in its two rulings, Colkitt has not presented any evidence that GFL did anything but lawfully engage in short sales of National Medical and EquiMed stock. The fact that these short sales may have contributed to a decline in the stocks' prices is not evidence of deceptive or manipulative conduct, for there is no reason to believe these prices were

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Colkitt clearly created genuine issues as to whether GFL's short sales affected the prices of National Medical and EquiMed.

depressed artificially. *See Sullivan & Long, Inc. v. Scattered Corp.*, 47 F.3d 857, 864 (7th Cir. 1995) (concluding that defendant's "unprecedented massive short selling" did not create "a false impression of supply and demand" because on the other side of defendant's transactions were "real buyers, betting against [defendant], however foolishly, that the price of [the] stock would rise"); *Olympia Brewing*, 613 F. Supp. at 1296 (stating that "short selling is simply not unlawful, even in large numbers and even if the trading does negatively affect the purchase price"). Indeed, the district court stated it well when it wrote that it is unreasonable "to infer unlawful intent from lawful activity alone." *GFL Advantage Fund, Ltd. v. Colkitt*, No. 4:CV-97-0526, Memorandum and Order at 19 (M.D. Pa. July 17, 2000).

In the cases Colkitt cites in which courts concluded that a party's short selling was part of a scheme to manipulate stock prices, the short selling was in conjunction with some other deceptive practice that either injected inaccurate information into the market or otherwise artificially affected the price of the stock. *See Russo,* 74 F.3d at 1387, 1390, 1391 (defendants used short sales in concert with "unauthorized placements" and "parking" of stock in customers' accounts to generate false credits that funded their "stock-kiting scheme" designed to artificially inflate stock prices); *United States v. Regan,* 937 F.2d 823, 829 (2d Cir. 1991) (defendants sought to depress temporarily the price of stock by arranging to have 40,000 shares sold short secretly to a broker-dealer without disclosing to the dealer the identity of the seller or the moving party behind the deal); *United States v. Charnay,* 537 F.2d 341, 344 (9th Cir. 1976) (to facilitate a take-over bid, defendants artificially depressed stock prices by getting others to sell 86,100 shares short and

"guaranteeing these sellers by secret understanding a recovery of $22 per share irrespective of the price obtained on the Exchange"); *Advanced Magnetics, Inc. v. Bayfront Partners, Inc.*, 1996 U.S. Dist. LEXIS 324, No. 92 Civ. 6879 (CSH), 1996 WL 14440 (S.D.N.Y. Jan. 16, 1996) (defendant attempted to depress stock prices through short sales that contravened Section 10(a) of the Exchange Act and Rule 10a-1 thereunder, which prohibits a short sale "below the price at which the last sale" of the security was reported), vacated in part on other grounds, 106 F.3d 11 (2d Cir. 1997).

The remaining cases of market manipulation Colkitt cites likewise involved either injection of inaccurate information into the market or creation of a false impression of supply and demand for a stock. *See Santa Fe Indus.*, 430 U.S. at 467, 97 S. Ct. at 1298 (defendant obtained "fraudulent appraisal" of stock that severely undervalued its worth "in order to lull the minority stockholders into erroneously believing that [its cash-exchange offer] was generous"); *Crane Co. v. Westinghouse Air Brake Co.*, 419 F.2d 787, 792-93 (2d Cir. 1969) (in an effort to inflate prices and thwart a corporate take-over, defendant "painted the tape" by purchasing large blocks of stock in the open market at inflated prices while simultaneously making large secret and unreported sales at lower prices to partially finance the purchases); *Blech*, 928 F. Supp. at 1286, 1298 (defendant arranged "sham transactions" to inflate prices by improperly directing trades into and out of brokerage accounts at the firm without the authorization of the owners of the accounts); *SEC v. Kimmes*, 799 F. Supp. 852, 856-57 (N.D. Ill. 1992) (defendant maintained artificially high stock prices by buying and selling stock through "undisclosed nominee accounts," distributing "false and misleading registration statements,"

and filing "false and materially misleading period reports" with the SEC), aff'd sub nom., *SEC v. Quinn,* 997 F.2d 287 (7th Cir. 1993); *SEC v. Malenfant,* 784 F. Supp. 141, 144-45 (S.D.N.Y. 1992) (defendant arranged "matched buy and sell orders" to "create a misleading appearance of active trading in the Texscan common stock" and thus drive up the price of the stock). Once again, Colkitt fails to proffer any evidence that GFL engaged in any such inappropriate conduct.

Colkitt attempts to overcome this dearth of evidence of deceptive or manipulative conduct on the part of GFL by claiming that short sales, by their very nature, "convey to market participants negative information about the prospects of the firm." Br. of Appellant at 39. Colkitt's argument misses the mark, however, because conveying negative information about a firm does not constitute market manipulation unless the information is untruthful. Indeed, legitimate short sales often convey negative information about a company insofar as short sales suggest that a stock's price is overvalued, but that does not mean that such sales distort the market. To the contrary, short selling can help move an overvalued stock's market price toward its true value, thus creating a more efficient marketplace in which stock prices reflect all available relevant information about the stock's economic value. *See Sullivan & Long,* 47 F.3d at 861-62.

Colkitt maintains that National Medical and EquiMed were not overvalued. He insists that, because GFL did not argue before the district court that it sold short because it believed the stocks were overvalued, Colkitt is entitled to the inference that "the short sales were made at least in part to convey to the market the false impression that the stocks were overvalued so as to result in a decline in share prices." Br. of

Appellant at 40 (emphasis in original). It would not be reasonable to draw such an inference, however, for to do so would fly in the face of uncontradicted evidence that the prices of National Medical and EquiMed were on a dramatic slide before and after GFL's short sales. If we were to draw any inference from the record evidence about the value of National Medical and EquiMed, it would be that the market considered the stocks to be overvalued and that GFL simply was responding to market forces, rather than distorting them, by engaging in short sales.

An examination of Colkitt's other requested inferences,[7] *see* Br. of Appellant at 30-35, exposes Colkitt's claims for what they are -- nothing more than a general attack on the lawful practice of short selling. For instance, Colkitt's first two inferences -- that GFL had a "unique financial incentive" to depress the prices of National Medical and EquiMed because its profits increased as the market prices decreased,[8] and that short selling "conveys negative

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[7] The parties disagree about the standard of review that should be applied to Colkitt's requested inferences. GFL contends that the standard is abuse of discretion because Colkitt raised these inferences for the first time when it filed its motion for reconsideration. Colkitt maintains that the standard is plenary because he raised all of the evidence and advanced all of the arguments at earlier stages in the litigation. This point is moot, however, because we would uphold the district court's rulings with respect to the inferences under either standard.

[8] Colkitt believes that GFL's incentive to depress prices is "unique" because the structure of the convertible notes allows GFL to receive more shares -- and thus higher profits -- as the stocks' prices decline. This incentive, however, is not unique to GFL's situation. All short sellers receive higher profits as the stock's price declines. Indeed, these higher profits in the face of declining prices

information" about the company being short sold and contributes to a drop in share prices -- are general criticisms of short selling. These inferences, even if granted, are of no help to Colkitt in trying to prove market manipulation, inasmuch as short selling is a lawful investment strategy. Colkitt's next three requested inferences -- that GFL's short sales constituted a large percentage of shares sold on a daily basis, that GFL's short sales caused a 17.5% decline in National Medical and an 18.5% decline in EquiMed,[9] and that these price slumps allowed GFL to obtain an additional 11,658 shares of National Medical and an additional 27,882 shares of EquiMed from Colkitt – are equally unavailing. Once again, short selling, even in large volumes, is not in and

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are why traders engage in short sales. They are betting that the stock's price will decline, and if it does so, they will have to spend less money buying replacement stock to cover the borrowed shares, thus allowing them to pocket the difference.

Colkitt's differentiation between GFL and other short sellers based on the structure of the National Medical and EquiMed notes is misguided. Whether GFL acquires $100,000 worth of shares from Colkitt in exchange for debt (as GFL did here) or in exchange for cash (as short sellers normally do when they cover) is irrelevant. In either situation, GFL will be able to obtain more shares from Colkitt if prices decline. Thus, if this "unique" incentive to depress prices is evidence that GFL engaged in market manipulation, then all short traders are likewise guilty of manipulating markets in violation of Section 10(b). Of course, this position is untenable, for as already explained, short selling is perfectly lawful.

[9] As already noted, *see supra* note 1, Colkitt greatly exaggerates EquiMed's price decline. The price of EquiMed on the day of the GFL's first short sale on November 8, 1996, was $5.25 per share, and its price on the day of GFL's last short sale on November 22, 1996, was $5.13. Consequently, the price of EquiMed dipped only $.12, or 2.3.

of itself unlawful and therefore cannot be regarded as evidence of market manipulation. That short selling may depress share prices, which in turn may enable traders to acquire more shares for less cash (or in this case, for less debt), is not evidence of unlawful market manipulation, for they simply are natural consequences of a lawful and carefully regulated trading practice.[10]

Colkitt's remaining inferences are equally groundless. Because a court is required to indulge only reasonable inferences, we reject Colkitt's last three requested inferences. For instance, Colkitt insists that GFL's use of four different brokers to execute the short trades is evidence that GFL tried to conceal its short sales from market participants, including Colkitt. This inference is unreasonable as GFL needed to use four brokers because none of them had enough shares necessary for GFL to borrow to carry out all of its short sales, which is not unusual when dealing with small cap

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[10] A passage in Colkitt's reply brief further undermines his theory that short sales are manipulative because they depress prices. He writes: "It is reasonable and makes economic sense to infer that short selling drives down share prices, because each short sale is, itself, a 'sale,' increasing supply . . . ." Reply Br. of Appellant at 15 (emphasis added). In other words, Colkitt believes that short sales are manipulative because they increase the stock's supply and drive down its price. This, of course, is true (assuming demand remains constant), but it is also true for all stock sales, whether they are from long positions or short positions. The rationale of Colkitt's theory would lead to the absurd result of outlawing any sales practice that increases a security's supply and consequently may affect its price. Colkitt fails to understand that increasing the supply of stocks by selling them on the open market in legitimate transactions to real buyers does not artificially affect prices and therefore cannot be manipulative.

stocks. *See* Br. of Appellee at 39 (citing Cason Aff. P 13 (App. 001080)).

Colkitt's next requested inference relates to GFL's assertion that it sold National Medical and EquiMed short to hedge against the stocks' declining prices and to lock in the notes' 17.5% and 18.5% profit spreads. Colkitt offers expert testimony that GFL's short sales could not have been part of a legitimate hedging strategy because too much time elapsed between the short sales and the exchange demands. The expert avers that if GFL were only trying to protect itself against declining prices after it made its exchange demand, it could have eliminated that "delivery risk" by selling short during the five-day period before the exchange demand, thus locking in the sale price during the same period the average closing price would be determined. Because GFL waited so long after the short sales to make its exchange demands, the expert contends GFL was not simply hedging against slumping prices, but was "increasing the likelihood of increasing profits through artificially (and temporarily) lowering the price of EquiMed."[11] Br. of Appellant at 16-17 (quoting Expert Report of Professor Steven R. Grenadier P 20. (App. 000860-000861)).

Accepting as true Grenadier's position that GFL could have hedged against all risk by selling short during the five-days prior to the exchange demands, a court reasonably could

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[11] Grenadier mentions only EquiMed because GFL sold National Medical short during the five-day period prior to its exchange demands to the stock. Therefore, even under Grenadier's theory, GFL's short trades of National Medical qualify as a legitimate hedging strategy.

infer that GFL not only sought to protect itself, but also endeavored to reap further profit from the stocks' declining prices by selling short. To infer that these "premature" short sales were executed to manipulate prices, however, would be an unreasonable leap. Indeed, Grenadier admits in his deposition that he does not have an opinion about whether GFL's short sales artificially depressed the prices of EquiMed stock. *See* Grenadier Dep. at 37 (App. 001016). Therefore, although it may be reasonable to infer from Grenadier's report that GFL's short sales were intended not only to hedge against declining prices but to profit from them, it would be unreasonable to infer that GFL's short sales were deceptive or manipulative, especially considering that the expert concedes that he does know whether the trades had the effect of manipulating the prices.[12]

Finally, in the words of the district court, Colkitt's last requested inference amounts to "baseless and desperate mudslinging." Colkitt asserts that GFL was sued twice "for engaging in manipulative short selling" thus evidencing that it engaged in that type of conduct with regard National Medical and EquiMed stock. Br. of Appellant at 35. GFL

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[12]Other portions of Grenadier's report also appear to undermine such a conclusion. In particular, Grenadier endorses the conclusions of Harvard Business School's Paul Asquith and Lisa Meulbroek that short trading would have an impact on the value of the securities if the number of shares sold short constituted 2.5 or more of the total outstanding shares. *See* Grenadier Dep. at 80-81 (App. 001017-001018). In this case, GFL sold short a total of 78,700 shares of EquiMed, which constituted only .275 of EquiMed's 28,589,717 outstanding shares. Therefore, under the standard embraced by Colkitt's own expert, GFL's short sales of EquiMed stock would not be expected to have a noticeable impact on the stock's price.

responds that it was not even involved in *Global Intellicom, Inc. v. Thomson Kernaghan & Co.*, 1999 U.S. Dist. LEXIS 11378, No. 99- CIV-342, 1999 WL 544708 (S.D.N.Y. July 27, 1999). Instead, the case involved a former employee whose allegedly unlawful conduct occurred after he left GFL. GFL also asserts that the action in *JTS Corp. v. GFL Advantage Fund, Ltd.* was dismissed in the early stages of the litigation after it filed for Rule 11 sanctions against the plaintiff. Based on GFL's averments, it would be entirely inappropriate to grant Colkitt's requested inference that these two lawsuits are evidence of GFL's alleged market manipulation in this case.

At bottom, the core of Colkitt's argument is premised on his belief that short selling artificially depresses prices and presumably should be banned as a market manipulation. Unfortunately for Colkitt, however, short selling is lawful, and courts have held that short selling, even in massive volume, is neither deceptive nor manipulative when carried out in accordance with SEC rules and regulations. *See Sullivan & Long,* 47 F.3d at 864-65. Therefore, to make out a claim of market manipulation, Colkitt must present evidence that GFL engaged in some other type of deceptive behavior in conjunction with its short selling that either injected inaccurate information into the marketplace or created artificial demand for the securities. Colkitt has offered nothing but evidence that GFL engaged in lawful short sales of National Medical and EquiMed, which alone is insufficient to prevail on a claim of market manipulation in violation of Section 10(b) and Rule 10b-5.

Another reason why Colkitt's market manipulation claim fails is because he has not met the scienter requirement

by offering evidence that GFL engaged in short sales for the purpose of artificially depressing the prices of National Medical and EquiMed stock. Citing our opinion in *In re Advanta Corp. Securities Litigation,* 180 F.3d 525, 535 (3d Cir. 1999), Colkitt argues that he has met the recklessness standard for liability under Section 10(b). He contends that GFL's conduct constitutes "an extreme departure from the standards of ordinary care" and "presents a danger of misleading buyers and sellers that is either known to the defendant or is so obvious that the actor must have been aware of it." *Id.* (internal quotation marks omitted). According to Colkitt, evidence of GFL's alleged recklessness includes: GFL's "powerful economic incentive" to depress the stocks' prices; "voluminous scholarly evidence" that GFL's short sales would convey a "negative impression" of the companies; the dramatic drop in the stocks' prices during the period of GFL's short selling; the additional 39,540 shares that GFL "extracted" from Colkitt because of the declining prices; GFL's use of four brokers to conceal his short sales; the conclusion of Colkitt's expert that GFL's short sales were not part of a legitimate hedging strategy; and GFL's having been sued twice for similar conduct.

In essence, Colkitt recycles his arguments that he advanced in support of his contention that GFL's short trades were manipulative and deceptive. Some of this evidence and the requested inferences to be taken therefrom already have been discredited -- GFL's use of multiple brokers, whether GFL's short sales were a legitimate hedge strategy, and the alleged lawsuits against GFL for engaging in short selling -- and the rest of the evidence and inferences are, once again, general attacks on the practice of selling short -- the powerful incentive to depress prices, the negative impression of the

company conveyed by short sales, the actual drop in National Medical and EquiMed prices, and the additional shares GFL obtained because of the declining prices. All that this information proves is that GFL engaged in the lawful practice of selling stock short and that these short sales may or may not have affected the price of National Medical and EquiMed stock. This evidence neither establishes that GFL's short sales were manipulative nor demonstrates that GFL executed the trades for the purpose of depressing the stocks' prices. Perhaps, if Colkitt had offered evidence that GFL's short sales violated SEC rules (for instance, if GFL failed to cover properly the short sales in violation of Rule 10a-2, or if GFL made short sales below the last sales price in violation of Rule 10a-1), Colkitt might have been able to establish that GFL's conduct was intentionally or recklessly manipulative or deceptive. In the absence of evidence that GFL engaged in any wrongful conduct, however, Colkitt's claim of market manipulation must fail. Therefore, we will affirm summary judgment in favor of GFL with respect to the market manipulation claim.

## C. SECURITIES FRAUD

Colkitt also claims that the notes should be voided pursuant to Section 29(b) on the grounds that GFL committed securities fraud in violation of Section 10(b) and Rule 10b-5 when it failed to disclose its intent to manipulate the prices of National Medical and EquiMed stock through short sales. GFL responds that it had no duty to disclose its intent to engage in short sales and that Colkitt has not established that he either relied on this alleged omission of fact or suffered a cognizable injury as a result of the reliance.

1. Elements of Securities Fraud Under Section 10(b) and Rule 10b-5

It is well settled that a claim of securities fraud under Section 10(b) requires proof "that the defendant (1) made misstatements or omissions of material fact; (2) with scienter; (3) in connection with the purchase or sale of securities; (4) upon which plaintiffs relied; and (5) that plaintiffs' reliance was the proximate cause of their injury." *Weiner v. Quaker Oats Co.*, 129 F.3d 310, 315 (3d Cir. 1997) (citation and internal quotations omitted). The parties apparently agree that the third element has been established, as there is no dispute that the alleged fraud was related to the purchase or sale of National Medical and EquiMed securities. Therefore, Colkitt must establish genuine issues with respect to the following elements: omissions of material fact, reliance, cognizable injury, and scienter.[13]

2. Evidence Supporting Colkitt's Claim of Securities Fraud

Colkitt asserts that GFL concealed from him two critical pieces of information that constitute omissions of material fact: (1) GFL's intention to sell short National Medical and EquiMed stock; and (2) GFL's actual short sales of the stock. Colkitt maintains that GFL had an affirmative duty to disclose this information because it was material and he would not have entered into the contracts with GFL if he had known it planned to sell the stocks short.

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[13] Colkitt submits the same evidence of scienter in support of both his securities fraud claim and his market manipulation claim. *See supra* pp. 30-31.

Analysis of a securities fraud claim under Section 10(b) and Rule 10b-5 includes two steps: "First, was the defendant under a duty to disclose at the time at issue? Second, was the alleged omission or misstatement material? If, under the facts of this case, no duty to disclose exists, or if the undisclosed facts are not material, there is no liability under Rule 10b-5." *Staffin v. Greenberg,* 672 F.2d 1196, 1202 (3d Cir. 1982). A duty to disclose arises only when one party to a transaction has material information that the other party is entitled to have because of some relationship of trust and confidence between the parties, such as when one party is a fiduciary, corporate insider, or "tippee." *See Chiarella v. United States,* 445 U.S. 222, 229, 100 S. Ct. 1108, 1115, 63 L. Ed. 2d 348 (1980). The Supreme Court has determined that "an omission of fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding" whether to invest. *Basic, Inc. v. Levinson,* 485 U.S. 224, 231, 108 S. Ct. 978, 983, 99 L. Ed. 2d 194 (1988) (quoting *TSC Indus., Inc. v. Northway, Inc.,* 426 U.S. 438, 449, 96 S. Ct. 2126, 2132, 48 L. Ed. 2d 757 (1976)). Materiality is a mixed question of law and fact and should be decided as a matter of law "only when the disclosures or omissions are so clearly unimportant that reasonable minds could not differ." *In re Craftmatic Sec. Litig.,* 890 F.2d 628, 641 (3d Cir. 1990).

Colkitt's securities fraud claim falters for at least one and possibly two reasons. To start with, he failed to present any evidence that GFL intended to engage in short sales at the time it loaned the money to Colkitt. *See In re Phillips Petroleum Secs. Litig.,* 881 F.2d 1236, 1245 (3d Cir. 1989) (stating that "a statement of intent need only be true when made; a subsequent change of intention will not, by itself,

give rise to a cause of action under Section 10(b) or Rule 10b-5"). More significantly, even if we can draw an inference that GFL had such a plan, it did not have a duty to disclose its intentions.

Colkitt argues that GFL had a duty to disclose its intentions because such a disclosure was necessary to clarify GFL's "implicit" representations that the debt-for-stock exchange price would be "based upon the accurate, unbiased and untainted market price quoted by the stock market." Br. of Appellant at 48. Colkitt explains that Section 10(b) and Rule 10b-5 impose a "duty to disclose any material facts that are necessary to make disclosed material statements, whether mandatory or volunteered, not misleading." *Craftmatic,* 890 F.2d at 641. He asserts that GFL's implicit guarantee that the exchange price would be based upon prevailing market forces "was rendered grossly misleading by GFL's failure to disclose that it intended to short sell EquiMed and National Medical." Br. of Appellant at 48-49.

We must reject Colkitt's argument for it is premised on the misguided notion that short sales distort markets and thus produce inaccurate, biased, and tainted market prices. As already explained, short sales executed in accordance with SEC rules and regulations not only are lawful, but also do not distort markets or create a false impression of supply and demand because they are legitimate transactions with real buyers on the other side of the sale who are betting that the stock's price will rise. *See Sullivan & Long,* 47 F.3d at 864. Contrary to Colkitt's assertion, GFL's short sales did not render its guarantee misleading, and GFL consequently did not have a duty to disclose to Colkitt its intention to engage in short selling. Therefore, because Colkitt failed to create a

genuine issue with respect to GFL making an omission of material fact, we will affirm summary judgment in favor of GFL with respect to the securities fraud claim.

## D. REINSTATEMENT OF FEDERAL SECURITIES LAW COUNTERCLAIMS

Colkitt argues that the district court erred when it dismissed his amended counterclaims for lack of specificity on February 2, 1999. He simply states that he pled his amended counterclaims, which span 30 pages, with sufficient specificity pursuant to Fed. R. Civ. P. 9. We need not consider these contentions, however, because, as we have explained, Colkitt failed to create genuine issues of material fact as to certain elements of his corresponding affirmative defenses, and thus, his counterclaims must fail on the merits as well.

## E. VIOLATIONS OF PENNSYLVANIA LAWS

### 1. Securities Claims

Section 1-508 of the Pennsylvania Securities Act bars the basing of certain suits on contracts that violate state securities laws. *See* Pa. Stat. Ann. tit. 70, §1-508 (1994). Section 1-401 of the Pennsylvania Securities Act prohibits the use of any "device, scheme or artifice to defraud" and the omission of any "material fact necessary in order to make statements made, in light of the circumstances under which they were made, not misleading." *Id.* §1-401(a), (b). Finally, Pennsylvania common law permits "the recipient of a misrepresentation [to] avoid the contract by showing that the misrepresentation was either fraudulent or material."

*Germantown Mfg. Co. v. Rawlinson,* 341 Pa. Super. 42, 491 A.2d 138, 141 (Pa. Super. Ct. 1985). As GFL asserts, these provisions are "functionally identical" to Section 29(b) and Section 10(b) of the Exchange Act. *See Rosen v. Communication Serv. Group, Inc.,* 155 F. Supp. 2d 310, 321 n.14 (E.D. Pa. 2001) ("Section 401 of the Pennsylvania Securities Act is modeled after Rule 10b-5 of the federal securities laws, and requires virtually the same elements of proof."). Therefore, Colkitt's state securities and common law fraud claims fail for the same reasons his federal securities claims fail.

2. Breach of Contract Claim

Colkitt argues that GFL is barred under Pennsylvania law from enforcing the notes because GFL committed a material breach of the contracts by refusing to accept Colkitt's prepayment, even though the notes contain no language prohibiting prepayment. Colkitt claims that he notified GFL in late December 1996 and early January 1997 that he would prepay all outstanding principal and interest on the notes, but GFL improperly rejected Colkitt's request for prepayment in hopes of declaring the notes in default and collecting millions of dollars in penalties.

GFL responds that it did not outright reject Colkitt's request for prepayment, but conditionally accepted the prepayment offer while reserving its rights to dispute the balance due. GFL not only disagreed with Colkitt about the amounts due, but refused to allow Colkitt to dictate the terms of any prepayment. Because of its conditional acceptance of Colkitt's offer, GFL maintains that whether or not the notes

permitted prepayment is not at issue.[14] GFL also argues that Colkitt's failure to tender any prepayments -- or any payments, for that matter -- undermines his position that he was attempting to make a full prepayment of outstanding principal and interest.

More importantly, however, Colkitt admitted that he was in material breach of his obligations on the notes before his first prepayment offer. In particular, he was in default on his interest obligations, he failed to maintain a pledge of securities in escrow, and he neglected to file required disclosure documents with the SEC. *See* Colkitt Dep. at 272-73, 261-62, 195-97 (App. 000581-000582, 000577-000578, 000552-000554). In light of these prior breaches, the district court did not err in granting summary judgment in favor of GFL on its breach of contract claim.

F. DAMAGES

The district court granted GFL damages in the amount of $21,121,989.39. Colkitt argues that the damages should be limited to principal and interest outstanding as of the date of his prepayment request, which would reduce the damages to $11,740,198.

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[14] The district court, responding to Colkitt's assertion that the notes do not permit GFL either to reject or accept conditionally an offer of prepayment, stated that "nothing in the agreements requires GFL to accept prepayment in an amount unilaterally imposed by Colkitt." *GFL Advantage Fund, Ltd. v. Colkitt*, No. 4:CV-97-0526, Memorandum and Order at 24 (M.D. Pa. Apr. 25, 2000). Thus, the court concluded that "GFL's acceptance while reserving its rights to the disputed amount does not constitute a breach of contract." *Id.*

First, Colkitt believes that GFL forfeited its right to collect anything but principal and interest when it rejected Colkitt's prepayment offer. As already addressed, he maintains that GFL's refusal to accept prepayment constituted a breach of contract and that if GFL had accepted his prepayment offer as it allegedly was obligated to do, he would have owed only $11,740,198. Colkitt cannot prevail on this argument, however, as he never actually tendered the $11,740,198 prepayment. Depriving GFL of the interest and penalties due on a balance that Colkitt never paid would reward him unfairly for his breach by allowing him to hold onto GFL's money interest free for nearly four and a half years.

Second, Colkitt argues that GFL is prohibited from recovering both the 20.5%/22% "premium" and the 14% "default interest" because they constitute an unenforceable penalty "that is disproportionate to the value of the performance promised or the injury that has actually occurred." Br. of Appellant at 64 (quoting *Finkle v. Gulf & Western Mfg. Co.*, 744 F.2d 1015, 1021 (3d Cir. 1984)). Colkitt claims that the "premiums" exceed the profit GFL would have been able to earn had it exchanged all of the debt for shares of National Medical and EquiMed and sold the shares on the market. He also insists that adding 14% "default interest" to the premiums is simply punitive and constitutes unenforceable liquidated damages.

We reject Colkitt's request to reduce the damage award. Both the "premiums" and the "default interest" compensate GFL for distinct economic losses suffered by GFL as a result of Colkitt's breach. The 20.5% and 22% "premiums" represent the grossed-up value of the 17% and

18% discounts guaranteed in the notes. The premiums are intended to restore GFL to the position where it would have been if GFL had been able to convert all of the debt into National Medical and EquiMed stock. In contrast, the "default interest" is intended to compensate GFL for damages it incurred since Colkitt's breach -- namely, the deprivation of its money over the past four and a half years. Not only were these provisions included in contracts that were negotiated at arm's length, but contrary to Colkitt's assertions, they also would restore GFL to the position that it would have held if Colkitt had not breached the notes.

## IV. CONCLUSION

For the foregoing reasons, we will affirm the orders of the district court entered on April 25, 2000, and July 17, 2000.

## APPENDIX C

**UNITED STATES DISTRICT COURT**
**FOR THE MIDDLE DISTRICT**
**OF PENNSYLVANIA**

**No. 4: CV-97-0526**

**[Filed July 17, 2000]**

GFL ADVANTAGE FUND, LTD.,)
Plaintiff, )
)
v. )
)
DOUGLAS R. COLKITT )
Appellant. )
)

JUDGE:
James F. McClure, Jr., United States District Judge.

**MEMORANDUM**

**BACKGROUND:**

On April 4, 1997, plaintiff GFL Advantage Fund, Ltd., commenced this action against defendant Douglas R. Colkitt, seeking to recover under written agreements pursuant

to which Colkitt borrowed funds from GFL and agreed, *inter*

*alia*, that GFL would have the right to exchange the principal amount of the debt for shares of National Medical Financial Services Corp. (NMFS) and EquiMed, Inc., held by Colkitt. Colkitt filed a multi-count counterclaim against GFL alleging that it engaged in a scheme to defraud him by engaging in a scheme of concentrated short selling of shares in NMFS and EquiMed. That action would force down the market price and enable GFL to exchange the debt for shares valued at an artificially low price, then reap substantial profits when the price of the shares exchanged rebounded to former levels.

On March 31, 1998, the court adopted, with modifications, the report and recommendation of the magistrate judge to whom the case originally was assigned. Counts I, III, IV, and V of Colkitt's counterclaim were dismissed without prejudice, based on the lack of specificity of the allegations pursuant to Fed. R. Civ. P. 9(b). Count II of the counterclaim was dismissed with prejudice, subject to a motion for reinstatement should the Third Circuit recognize a cause of action under Section 17 of the Securities Act of 1933, 15 U.S.C. §77q(a). Count VI of the counterclaim was dismissed with prejudice, an action which was concluded on reconsideration to be in error, and the order was corrected to make the dismissal without prejudice.

On April 20, 1998, Colkitt filed an amended counterclaim complaint for the purpose of curing the deficiencies which led to dismissal of the original counterclaim. We again concluded that the factual allegations were insufficient to support a claim of fraud, and the amended counterclaim was dismissed without prejudice.

On April 25, 2000, the court granted a motion by GFL

for summary judgment, and denied (1) a motion by Colkitt to compel a deposition and expert witness disclosures, (2) a motion by Colkitt for additional discovery, and (3) a motion by Colkitt to strike the affidavit of Robert D. Cason. We also directed the parties to provide supplemental briefing on the issue of damages.

Before the court are a motion by Colkitt for reconsideration of our Memorandum and Order of Court dated April 25, 2000, and the parties' supplemental briefs on damages.

**DISCUSSION:**

**I. STANDARD FOR RECONSIDERATION**

"The purpose of a motion for reconsideration is to correct manifest errors of law or fact or to present newly discovered evidence." *Harsco v. Zlotnicki,* 779 F.2d 906, 909 (3d Cir. 1985) (citations omitted), *cert. denied*, 476 U.S. 1171, 90 L. Ed. 2d 982, 106 S. Ct. 2895 (1986). "Therefore, a court may properly grant a party's motion for reconsideration in any of the following circumstances: '(1) the development of an intervening change in the law, (2) the emergence of new evidence not previously available, or (3) the need to correct a clear error of law or prevent a manifest injustice.'" *In re TMI Litigation Cases Consolidated II,* 922 F. Supp. 997, 1008 (M.D. Pa. 1996)(Rambo, C.J.; quoting *Cohen v. Austin,* 869 F. Supp. 320, 321 (E.D. Pa. 1994); citations omitted in *In re TMI*). The granting of a motion to reconsider is an extraordinary remedy and a court should not do so when the motion is merely a re-styling or rehash of issues previously presented. *McConocha v. Blue Cross and*

*Blue Shield Mutual of Ohio,* 930 F. Supp. 1182, 1184 (N.D. Ohio 1996). A court should consider neither new evidence nor a new legal theory which could have been presented on the original motion, taking into account due diligence. *Id.* Mere disagreement with the court is a ground for an appeal, not a motion for reconsideration. *Id.*

## II. STATEMENT OF FACTS

The facts recited herein have been taken from our prior memorandum, since no new evidence or factual matter is the basis for Colkitt's motion. Material which was bracketed in our prior memorandum for purposes of explaining our resolution of a dispute related to factual matters has been omitted.

Colkitt was the founder and majority shareholder of NMFS, holding approximately 2.8 million of the 7,426,844 shares of common stock outstanding as of May, 1996, at which time NMFS was trading at approximately $12.875 per share. EquiMed was created in February, 1996, as the result of a merger between Colkitt's wholly-owned practice management firms and Equivision, a publicly held opthomology[1] company in which Colkitt owned a 28% interest. Colkitt owned 20,783,633 shares of the 28,589,717 shares of EquiMed common stock outstanding as of February, 1996. EquiMed was trading at approximately $14.00 per

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[1] GFL uses the word "opthomology" in its statement of facts, probably referring to ophthalmology. "Opthomology" is not in either of the dictionaries consulted by the court. THE RANDOM HOUSE DICTIONARY OF THE ENGLISH LANGUAGE 1358, 1360 (2d ed. 1987); DORLAND'S MEDICAL DICTIONARY 1185, 1187 (28th ed. 1994).

share after a contemporaneous Initial Public Offering. EquiMed decreased in price to $7.75 per share by August, 1996, the date of the GFL/EquiMed transaction.

Despite his vast stock holdings, including without limitation his ownership interest in NMFS and EquiMed, Colkitt sought to obtain additional liquidity in the spring of 1996 in the range of $15-25 million in order to fund his aggressive entry into unrelated business ventures. Colkitt approached a number of commercial lenders in his effort to obtain this financing including, without limitation, ING Bearings, Bankers Trust, Republic Bank, and G.E. Capital. However, Colkitt did not obtain financing from any of these lenders nor any other commercial bank or traditional lender in the amount desired.

Colkitt engaged Wharton Capital Corp. as his agent to locate financing sources acceptable to Colkitt. The basic financial parameters of a prospective convertible transaction, whereby. Colkitt's shares in either NMFS or EquiMed would be converted into cash, were set by Colkitt before any potential lenders were identified. Wharton identified GFL as a potential lender to Colkitt.

On or about May 24, 1996, Colkitt borrowed $3,000,000.00 from GFL and executed certain transaction documents setting forth, among other things, Colkitt's repayment obligations. Said documents included the NMFS Exchangeable Note, the NMFS Registration Rights Agreement, and the NMFS Pledge Agreement.

Among other terms, the NMFS note provided GFL

after 30 days with the right to exchange an amount up to one half of the original principal amount of the NMFS Note for fully paid and non-assessable shares of NMFS common stock owned by Colkitt. Beginning 60 days after the date of the NMFS Note, GFL was entitled to exchange the remaining one half of the outstanding principal amount of the NMFS Note for such shares of NMFS common stock. The NMFS Note set the exchange price at 82% of the Average Market Price of NMFS common stock, as that term is defined in the NMFS Note. The right to exchange was limited to the outstanding principal.

Colkitt also agreed to pay interest on the unpaid principal balance at a rate of 7% per annum, payable on the first day of each February, May, August, and November, beginning on August 1, 1996, and at maturity.

On or about August 5, 1996, Colkitt borrowed an additional $10,000,000.00 from GFL and executed certain transaction documents setting forth, among other things, Colkitt's repayment obligations. Said documents included the EquiMed Exchangeable Note, the EquiMed Pledge Agreement, and the EquiMed Registration Rights Agreement. Beginning 60 days after the date of the EquiMed Note, GFL had the right to exchange up to one half of the original principal amount of the EquiMed Note for fully paid and non-assessable shares of EquiMed common stock owned by Colkitt. Beginning 90 days after the date of the EquiMed Note, GFL could exchange the remaining one half of the principal amount of the EquiMed Note for such shares of EquiMed common stock. The EquiMed Note set the exchange price at 83% of the Average Market Price of EquiMed common stock, as that term is defined in the EquiMed Note.

The right to exchange was limited to the outstanding principal.

Colkitt also agreed to pay GFL interest on the unpaid principal sum at the rate of 4% per annum, payable on the first day of each February, May, August, and November, beginning on November 1, 1996, and at maturity.

The Notes provide that Pennsylvania law controls the Notes and other transaction documents entered into by and between Colkitt and GFL. Neither the EquiMed nor the NMFS transaction documents included any provision which prohibited or otherwise limited GFL from entering into a short position in the stock of either NMFS or EquiMed at any time.

Colkitt received cash from GFL at closing in the amounts of $3,000,000.00 less broker's commission in conjunction with the NMFS transaction and $10,000,000.00 less broker's commission in conjunction with the EquiMed transaction.

In order to allow GFL to sell shares which it was to receive in exchange for debt under the terms of the NMFS Note, Colkitt was required to cause NMFS to prepare and file with the SEC a post-effective amendment to NMFS's Registration Statement on Form SB-2 within 15 days from the date of the NMFS Note, or by June 7, 1996. Colkitt failed to cause NMFS to file such a post-effective amendment with the SEC within the time required. Colkitt failed to pay interest on the outstanding principal under the NMFS Note on August 1, 1996, and at any time thereafter. Colkitt failed to maintain in escrow shares of EquiMed common stock in an amount equal

to not less than 150% of the current outstanding principal balance due under the EquiMed Note, as required by the transaction documents. Colkitt also failed to honor GFL's EquiMed Exchange Notice dated January 3, 1997, at which time GFL attempted to exchange $ 1,430,000.00 of principal into approximately 500,685 shares of EquiMed common stock.

NMFS and EquiMed notified GFL on January 9, 1997, that they would no longer honor any further Exchange Notices because GFL had called a default under the applicable transaction documents.

The Notes contain cross-default provisions, which provide that a default under either of the Notes constitutes a default under the other Note. Colkitt specifically agreed to pay to GFL, upon default, all unpaid principal then due under the Notes, all accrued and unpaid interest on the unpaid principal balance together with an amount equal to 22% (NMFS) or 20.5% (EquiMed) of the unpaid principal balances then due under the Notes. Colkitt specifically waived demand, presentment or notice in the event of a default under the Notes.

The following exchange requests were submitted to Colkitt. All were honored except as noted:

| Date of Exchange | EquiMed | NMFS |
|---|---|---|
| September 13, 1996 | | $ 250,000.00 principal for 34,130 shares at $7.32/share |

| Date of Exchange | EquiMed | NMFS |
|---|---|---|
| September 19, 1996 | | $135,000.00 principal for 18,726 shares at $ 7.21/share |
| October 10, 1996 | | $ 257,000.00 principal for 47,081 shares at $ 5.46/share |
| November 27, 1996 | $ 560,000.00 principal for 150,555 shares at $3.72/share | |
| December 5, 1996 | | $ 100,000.00 principal for 14,845 shares at $ 6.74/share |
| December 19, 1996 | | $ 200,000.00 principal for 34,588 shares at $ 5.78/share |
| January 3, 1997 | $1,430,000.00 principal for 500,685 shares at $ 2.86/share Dishonored. | |
| January 7, 1997 | | $ 2,058,000.00 principal for 100,223 shares at $ 5.44/share Withdrawn as moot. |

Pursuant to the exchange procedures agreed upon by the parties, GFL would forward to Colkitt a "Notice of Exchange of Exchangeable Note" which would set forth, among other things, the exchange date, the dollar amount of principal balance which GFL sought to exchange, together with the number of shares which GFL was entitled to receive in exchange. Upon receiving a Notice of Exchange, it was agreed that Colkitt thereafter would process said request and forward instructions designed to release to GFL the appropriate number of shares. In a number of cases, however, the actual stock certificates received by GFL bore a restrictive legend which restricted the subsequent transfer of such shares. As a result, GFL was often required to take the additional step of requesting from the applicable transfer agent "clean," non-legend shares in exchange for the legended shares. Whether for this or other reasons, GFL did not receive physical possession of freely assignable certificates from Colkitt until approximately 11, 18, 25, 33, 34, and 46 days after the date of the six honored Exchange Notices.

The price of each exchanged share of stock was "locked in" at a five-day average of the stock immediately prior to the date of the Exchange Notice. The risk of a decrease in the price of the converted stock therefore was shifted from Colkitt to GFL as of the date of the conversion request.

According to GFL, in order to hedge against the risk of a price decrease, and otherwise to take advantage of current market conditions, GFL entered into the following short sales:

NMFS

| Date | Closing Price | Shares Sold | Price Change from Prior Day |
|---|---|---|---|
| 9/13/96 | $10.00 | 32,500 | +1 3/8 |
| 9/16/96 | 9.13 | 15,000 | -7/8 |
| 9/17/96 | 9.25 | 5,000 | +1/8 |
| 10/11/96 | 8.25 | 3,000 | +1/4 |
| 10/14/96 | 8.25 | 7,000 | no change |

EQUIMED

| Date | Closing Price | Shares Sold | Short Sale Price | Change from Prior Day |
|---|---|---|---|---|
| 11/8/96 | $ 5.25 | 18,400 | 10,000- $5.50<br>8,400- 5.48 | -1/4 |
| 11/11/96 | 5.25 | 32,500 | 5.38 | no change |
| 11/12/96 | 5.00 | 16,000 | 5.25 | -1/4 |
| 11/14/96 | 5.25 | 8,500 | 5.25 | +1/4 |
| 11/22/96 | 5.13 | 3,300 | 5.00 | +3/8 |

GFL did not engage in any other short trade, either for its own account or in conjunction with any other affiliate or unrelated third party, except as set forth in the tables above. The average closing price of NMFS showed an increase between January, 1996, and May, 1996, but then declined steadily between May 1996 and January, 1998. The decline was from a peak of $12.875 on May 1, 1996, to a low of $0.4375 on January 2, 1998. The average closing price of EquiMed showed a similar pattern, peaking on February 1, 1996, at $15.00, then declining to a low of $2.4583 on January 2, 1998.

Colkitt has no independent knowledge of how many shares GFL actually shorted in NMFS and EquiMed, and his suspicions concerning GFL were based, in large part, upon information which he received "third hand, double hearsay probably..." Colkitt never disclosed to GFL his alleged suspicions that GFL was engaged in a manipulative market scheme of any kind until Colkitt filed his answer, affirmative defenses and counterclaim in this action on June 5, 1997. Colkitt attempted to negotiate the prepayment of the Notes in December, 1996, and January, 1997.

GFL claims damages totaling $20,043,469.73 as of December 31, 1999.

## III. PRIOR RULING

The focal point of Colkitt's challenge to our prior ruling is the following language:

> Both parties cite *In re Olympia Brewing Co. Securities Litigation,* 613 F. Supp. 1286, 1292 (N.D. Ill. 1985), for the principle that short selling is not illegal *per se*, but may be unlawful if it is part of a scheme to manipulate the market. The court explained:
>
> > Furthermore, the court reminds plaintiffs that short selling is simply not unlawful, even in large numbers and even if the trading does negatively affect the purchase price. Where the trading volume and prices

> simply reflect supply and demand based on accurate market information, this is lawful market behavior, not market manipulation. Hence, evidence of substantial short selling is necessary to plaintiffs' claims, but certainly does not prove them. Where the selling appears in all other respect to be lawful, the court will not draw the inference that an unlawful conspiracy to manipulate the market price took place.

*Id.* at 1296.

Despite the party's lengthy briefs, use of calculations such as percentages of daily sales versus monthly sales, etc., the theory espoused by Colkitt fails for one simple reason: he has failed to produce any evidence that the short selling by GFL had any substantial effect on the price of NMFS or EquiMed shares. That is, there is a simple causation problem which undermines all of Colkitt's arguments.

The decline in the price of NMFS began in May, 1996, well before the short sales of that stock by GFL in September, 1996. The decline continued through 1997 and

> into 1998. The decline in the price of EquiMed began in February, 1996, again well before any short sales of that stock by GFL in November, 1996. Colkitt fails to provide any evidence that the declines in price are attributable to false information injected into the market by the short sales and not to information otherwise available to the market. *See generally In re Scattered Corp. Securities Litigation,* 844 F. Supp. 416, 420 (N.D. Ill. 1994)(market manipulation under Rule 10b-5 refers to practices intended to mislead investors by artificially affecting market activity; quoting *Santa Fe Indus., Inc. v. Green,* 430 U.S. 462, 476, 51 L. Ed. 2d 480, 97 S. Ct. 1292 (1977)), *aff'd sub nom. Sullivan & Long, Inc. v. Scattered Corp.,* 47 F.3d 857 (7th Cir.), *reh'g en banc denied, cert. denied sub nom. Harkins v. Scattered Corp.,* 516 U.S. 818, 133 L. Ed. 2d 35, 116 S. Ct. 76 (1995).

Memorandum and Order of Court dated April 25, 2000, at 21-22.

Stated differently, we concluded that Colkitt's affirmative defenses necessarily were based on his claim that GFL's short sales constituted a scheme to manipulate the market, but his only evidence was the short selling itself. As the court in *Olympia Brewing* explained, since short selling is lawful, it is not permissible to infer from short sales alone that the party engaging in short sales is engaged in market

manipulation in violation of the securities laws and regulations.

## IV. COLKITT'S ARGUMENTS

In arguing for reconsideration, Colkitt mischaracterizes the holding of our prior memorandum. According to Colkitt, we "considered only whether there was evidence that GFL's short trades caused a movement in share prices. Finding no evidence, the Court held as a matter of law that there could have been no manipulative scheme for GFL to disclose." Brief in Support of Motion for Reconsideration at 3. Actually, our holding was that, as in *Olympia Brewing*, there was no evidence that the short sales affected the price, so that the short sales alone were not evidence of market manipulation. Memorandum and Order of Court dated April 25, 2000, at 22-23. Colkitt "fail[ed] to provide any evidence that the declines in price are attributable to false information injected into the market by the short sales and not to information otherwise available to the market." *Id.* at 22.

Unfortunately, in responding to Colkitt's motion, GFL "took the bait" and has expended considerable time and energy responding to Colkitt's arguments regarding the causation element of a claim under Section 10(b) (15 U.S.C. §78j(b)) and Rule 10b-5 (17 C.F.R. §240.10b-5). All of that discussion has little, if anything, to do with the issue before the court. The question was whether Colkitt had produced sufficient evidence to support his affirmative defense that GFL had engaged in market manipulation. Consistent with *Olympia Brewing*, we held that evidence of short sales is insufficient because those sales are lawful. There must be some circumstance beyond the mere occurrence of short sales

to suggest that the short sales were part of a scheme to manipulate the market. Since no such circumstances were present, we concluded that Colkitt's affirmative defense failed. The parties' arguments concerning the causation element of a Section 10(b) claim are misplaced.

Colkitt's segue into the realm of causation is our statement that "there is a simple causation problem which undermines all of Colkitt's arguments." Memorandum and Order of Court dated April 25, 2000, at 21. The "simple causation problem," which the parties have managed to complicate beyond all recognition, was the lack of evidence that the short sales had any effect on the price of the shares at issue. Absent such evidence, the short sales alone did not support an inference of market manipulation, and Colkitt's affirmative defense failed.

Colkitt argues, for the first time, that there was evidence of other circumstances which, in combination with the evidence of short sales, supports his contention that the agreements between the parties are void for fraud (common law and under the securities laws). First, he contends that GFL's "unique and direct pecuniary interest" was sufficient to establish a *prima facie* case. Brief in Support of Motion for Reconsideration at 5-6. He cites, *id.* at 6 n. 1, *Crane Co. Westinghouse Air Brake Co.*, 419 F.2d 787, 794 (2d Cir. 1969)(correct page is 795), *cert. denied*, 400 U.S. 822, 27 L. Ed. 2d 50, 91 S. Ct. 41 (1970), in support of that proposition. Actually, *Crane* is distinguishable, and the rule for which Colkitt cites *Crane* is incorrect in any event.

In that case, Crane sought a merger with Air Brake, but the directors of Air Brake opposed the merger and were

offered assistance by American Standard, Inc., to resist Crane's takeover attempt. *Id.* at 790-791. Crane extended a tender offer for Air Brake stock which was to expire on April 19, 1968, the "critical day" in the take-over battle. *Id.* at 792. Since the tender offer was an exchange of Air Brake stock at $50 per share, "the surest way to defeat the Crane offer was to run the price up to $50." *Id.* The stock opened on April 19 at 45 1/4, "giving Crane's tender offer a good prospect of success." *Id.*

Meanwhile, American Standard and the directors of Air Brake had met in special session on April 8 and agreed to merge the companies. *Id.* at 791. Air Brake's directors informed their shareholders of the agreement and solicited proxies in favor of the merger with American Standard. *Id.* Throughout this time, Crane accumulated shares of Air Brake stock to support its own merger proposal. *Id.*

At the close of trading on April 18, American Standard owned 367,000 shares of Air Brake, with a limit of 460,000 shares (10%) due to statutory and accounting restrictions. *Id.* at 792. On April 19, Standard engaged in a series of transactions involving the purchase of Air Brake stock and sales of the same shares, including an undisclosed sale of some 100,000 shares. *Id.* at 792-793. The purchases and sales represented a loss to American Standard of $500,000. *Id.* at 791. "The net result of this buying was to represent to the public, whose primary source of information is the tape, that there was a great demand for Air Brake at an increased value." *Id.* at 792-793. Stated another way, "[American] Standard had 'painted the tape' in Air Brake stock." *Id.* at 793. The Second Circuit summarized American Standard's activity as follows:

> Standard's extraordinary buying here, coupled with its large secret sales off the market, inevitably distorted the market picture and deceived public investors, particularly the Air Brake shareholders. The effect of these purchases was to create the appearance of an extraordinary demand for Air Brake stock and a dramatic rise in market price, as a result of which Air Brake shareholders were deterred from tendering to Crane. Concentrated open market bidding in a takeover battle may not in itself violate present laws and regulations, a question we do not decide here. Standard's actions here, however, in concealing from the public--and in particular from the Air Brake stockholders--the true situation as to the market it was making in Air Brake stock resulted in violations of sections 9(a)(2) and 10(b) of the [Securities Exchange] Act.

*Id.*

In the district court, Crane claimed that the transactions were illegal purchases of proxy votes and that there was market manipulation and fraud. The district court denied relief on both claims, but emphasized the vote purchasing claim because that was more vigorously pressed by Crane. On appeal, the Second Circuit did not address the vote purchasing claim because it was abandoned. On closer examination of the market manipulation claim, the Second Circuit reversed. *Id.* at 791-792. As described above, it concluded that American Standard plainly had acted with the intent to raise the price of Air Brake stock by deceiving

investors into thinking that there was active trading of, and demand for, the stock. In short, American Standard had engaged in market manipulation.

From all of this, Colkitt quotes a single sentence out of context and argues that it reflects error by this court. The sentence is, "When a person who has a 'substantial, direct pecuniary interest in the success of a proposed offering takes active steps to effect a rise in the market' in the security, we think that a finding of manipulative purpose is prima facie established." *Id.* at 795 (footnote omitted; quoted by Colkitt in his Brief in Support of Motion for Reconsideration at 6 n.1). Ignored by Colkitt is the next sentence, "Here we have even more than a motive to manipulate *joined with the requisite series of transactions*." *Id.* (emphasis added). The "requisite series of transactions" discussed throughout the opinion refers to the trading of Air Brake shares which raised the price of the stock, i.e. "active steps to effect a rise in the market."

There are, in effect, two layers of intent which must be established in a claim such as that described in *Crane*. The party accused of market manipulation first takes some action which will have an effect on the price of a security, such as buying shares. Its intent at that point is to complete the purchase. The question then is whether the purchase will have an effect on the price of the security such that false information is provided to the trading public. If the action taken will cause the price of the security to rise when, under normal market conditions, it would not rise, *and* the party taking that action benefits from the rise, one may infer that the party's purpose is to manipulate. This second showing is the other layer of intent to which we have referred, and the

sufficiency of the showing is what was at issue before the Second Circuit in Crane.[2] While the Second Circuit called this second layer the party's "manipulative purpose," it might also have used the term "fraudulent intent," since the difference between the two is the same as the difference between the intent of a party to take an action and the fraudulent intent by the same party to achieve a desired result (depriving another of property) through taking the action.

In this case, we do not reach the second layer of intent because Colkitt never established the first layer. That is, while it is clear that GFL made short sales, it is not clear that it did so with the intent to cause a decline in the price of the securities it purchased. The court in *Olympia Brewing*, as we have quoted and with which we agree, held that an intent to cause the change in price cannot be inferred from merely engaging in lawful activity such as short sales. There was no change in the price of the stock at issue in this case which may be attributed to the short sales by GFL, and Colkitt pointed to no evidence that GFL's short sales otherwise injected false information into the market. Colkitt's attempt to conflate this analysis with that of the Second Circuit, which presumed the intent to effect a change the price, is unconvincing.

We conclude, then, that *Crane* is distinguishable based on the stage in the analysis which was at issue. Also, it does not stand for the proposition that an allegedly injured party establishes a *prima facie* case merely by claiming that lawful

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[2] There were other issues before the Second Circuit, such as Crane's standing to assert the claim, which we do not address as being immaterial for present purposes.

activity by a party with a "unique and pecuniary interest" constitutes fraud.

Colkitt next cites to the fact that GFL engaged in "extensive" short sales during the relevant period. He quotes the following passage:

> When the volume and price are increased at times the stock price is particularly important to the manipulator, this is stronger evidence of a 10b-5 violation. ...*Comparable sales to stop an increase or to drive down the price would naturally fall in the same category*.

Colkitt's Brief in Support of Motion for Reconsideration at 6 n. 2 (quoting A. Jacobs, *Litigation and Practice under 10b-5* §139.03(d) nn. 10, 11; citations omitted and emphasis added by Colkitt). The same principle applies: Colkitt cannot show that GFL acted to increase the price, stop an increase, or drive down the price merely by referring to referring to lawful activity. There was *no* effect shown on the price of either EquiMed or NMFS stock, since the decline began well before the short sales and continued well after the short sales.

While we recognize that we risk mantric intonation of this principle, we reiterate: With respect to a claim of market manipulation, the alleged manipulator's intent to engage in unlawful activity is not proven with evidence of lawful activity absent further evidence that the lawful activity is part of an unlawful scheme because it is not reasonable to infer unlawful intent from lawful activity alone. Evidence that the lawful activity added information to the market which changed the price of the stock to the benefit of a person in a

unique position to benefit directly would constitute the "further evidence" to which we refer.[3] When, as in this case, there is no change in the price, the lawful activity itself cannot have provided false information to the market, and it is not reasonable to infer the intent to defraud under these circumstances.

Colkitt's next argument borders on (and may well enter the territory of) the frivolous. He argues that "EquiMed share prices declined during the period...," Brief in Support of Motion for Reconsideration at 6, and refers to "GFL's own evidence...," *id.* at 6 n. 3. The evidence on which Colkitt now relies was evidence to which he objected at the time of summary judgment. Memorandum of April 25, 2000, at 18-19.

The disingenuous argument continues with Colkitt pointing out that the closing price of EquiMed on December 2, 1996, was $4.1875 per share, down from $5.00-$5.25 during the period between November 8-14, 1996, although he probably means November 8-22, 1996, the period during which GFL made its short sales of EquiMed. Memorandum of April 25, 2000, at 18. What this argument ignores is that the price already was down from $15.00 per share on February 1, 1996, and declined to $2.4583 per share on

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[3] We have never, either in our prior memorandum or in this memorandum, stated that this "further evidence" must be an effect on the price of the allegedly manipulated shares. As an example, making a statement about a corporation is lawful activity. However, a public announcement concerning the corporation which the manipulator knows to be false and negative might constitute market manipulation; the falsity and negativity would be the requisite "further evidence."

January 2, 1998. It also ignores the already precipitous decline of the value of EquiMed stock: On October 15, 1996, the stock closed at $7.25 per share, but closed at $5.25 on November 8, 1996. In other words, the decline in price in the 3 1/2-week prior to the short sales by GFL was *greater* (both numerically and percentage-wise) than the decline during the approximately same-length period to which Colkitt refers ($2.00 or 27.6% in the period before the short sales versus $1.0625 or 20.2% in the period after the short sales began).[4] Colkitt's misleading "snapshot" is not evidence that the value of the shares was affected by the short sales: the free fall began before the short sales and continued well after the short sales.

Colkitt next points to evidence that short sales are "commonly used in manipulation schemes..." Brief in Support of Motion for Reconsideration at 6. This argument presumes that a manipulation scheme existed, and it is the absence of proof on this point that is Colkitt's problem. Regardless, that something is "commonly used" does not mean that it is so used in any given instance, nor that its use reflects the same purpose. The very fact that short selling is lawful suggests that it is not used exclusively for manipulation. To use an analogy, we suppose that it could be said that firearms are "commonly used" in murders. It does not follow that the use of a firearm is evidence of murder. Rather, *further evidence* such as a dead body, other forensic evidence, eyewitness testimony, etc., would be necessary to prove a murder. In the

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[4] These prices are reflected in the chart which we excluded but summarized because of Colkitt's objection. *See* Affidavit of Donald E. Stout, Appendix in Support of GFL's Motion for Summary Judgment, Exhibit E, at 7.

same way, the fact that short sales occurred is not evidence of a scheme of manipulation.

The next argument proffered by Colkitt is that GFL concealed its identity by using four different brokers for the short sales. Once again, Colkitt cites *Crane* and, once again, *Crane* is inapposite. The part of the discussion in *Crane* to which Colkitt cites, *id.* at 795-796, refers to the failure of American Standard to disclose its manipulation to investors as the basis for a claim of fraud, and the concealment of the identity of American Standard as evidence of fraudulent intent is not discussed. In fact, Colkitt's own footnote is inapposite to the rule he seems to assert: He states that short sellers can conceal their identities, Brief in Support of Motion for Reconsideration at 6, then cites authority relating to the concealment of sales (not identities), *id.* at 6 n. 5. Regardless, assuming that concealing one's identity as the holder of a short position may be evidence of an intent to defraud, Colkitt still has not established the existence of the scheme to do so. That is, if the value of the stock was affected, the fact that the short seller hid its identity might be evidence of a purpose to manipulate because it could reflect consciousness of guilt. Conversely, however, the absence of any effect, which in turn means no manipulation, renders the purported hiding of the short seller's identity meaningless.

Colkitt next argues that evidence consisting of an expert opinion rebutted GFL's explanation of the short sales as a legitimate hedging strategy. That GFL does not provide an explanation for lawful activity which an expert might consider unwise hardly renders the activity unlawful. Regardless, the evidence to which Colkitt refers does not really rebut GFL's proffered explanation. In its reply brief in

support of its motion for final summary judgment, GFL pointed out the limits on the expert's opinion and how, when presented with a hypothetical akin to the situation at hand, the hedging strategy would be reasonable. Deposition Testimony of Steven R. Grenadier, Ph.D. (Exhibit B to GFL's Reply Brief) at 135-136; Reply Brief at 6-7.

Finally, Colkitt states that "GFL and its advisors have been accused of engaging in the same type of manipulative short selling schemes in the past." Brief in Support of Motion for Reconsideration at 7 (citing *Global Intellicom, Inc. v. Thomson Kernaghan & Co.*, 1999 U.S. Dist. LEXIS 11378, No. 99 CIV342, 1999 WL 544708 (S.D.N.Y. July 27, 1999). We must agree with GFL that this assertion constitutes nothing more than "baseless and desperate mudslinging." Brief in Opposition to Motion for Reconsideration at 9. Colkitt refers to a person named Chau who was employed by an entity related to GFL (*not* GFL) and left that employment well before November, 1996. More importantly, the claims against Mr. Chau were dismissed. *Global Intellicom* 1999 at *11. Unsubstantiated accusations hardly constitute admissible evidence.

Colkitt's citation to *Global Intellicom* does give rise to one bit of irony, however, since it provides a basis for an additional reason for our prior holding. That court pointed out that the plaintiff could not have relied on any alleged omission by Mr. Chau and JNC (his then-employer) with respect to the intention to enter into future short sales. The reason that where can have been no reasonable reliance was that the plaintiff included terms forbidding short sales in contracts with other entities. "At the time of their negotiation, the

specter of short selling was a concern for both sides." *Id.* at *11.

In the same way, Colkitt included terms forbidding short sales in his agreements with Berckeley Investment Group, Ltd., also involving debentures convertible for NMFS stock. *Berckeley Investment Group, Ltd. v. Colkitt*, No. 4:CV-97-1242, slip op. at 5-7 (M.D. Pa. Dec. 7, 1999). Those agreements were executed at about the same time that the instant agreements were executed, and well after Colkitt had made known his essential terms for financing agreements. Thus, he cannot have reasonably relied on any omission on the part of GFL with respect to short sales.

Having reviewed Colkitt's new contentions at length, we conclude that he has no more evidence to prove his claims of fraud than on our original consideration, and the motion for reconsideration will be denied.

## V. DAMAGES

In our Memorandum and Order dated April 25, 2000, we directed the parties to file supplemental briefs relating to damages because Colkitt did not address the issue in opposing the motion for summary judgment. The briefs having been filed, the matter is ready for adjudication.

As a preliminary matter, we reject Colkitt's argument relating to the time that he purportedly offered prepayment of all of the principal and outstanding interest. The question of the prepayment offer was addressed in our memorandum and in an Order of Court dated November 5, 1999, and we rejected the notion that GFL's refusal to accept prepayment

on Colkitt's terms, i.e. without reserving its rights to disputed sums, constituted a breach of the agreements between the parties. Memorandum dated April 25, 2000, at 23-24.

The outstanding principal due at this time is $2,058,000.00 for the NMFS note and $9,440,000.00 for the EquiMed note. There can be no reasonable question that these sums are owed.

The next item of damages claims by GFL is the "Premium," representing the amount of money it would have earned as the discount from the market rate when it tendered the principal for the shares of stock. This exchange rate or exchange price was 82% of the Average Market Price of NMFS common stock and 83% of the Average Market Price of EquiMed common stock. These numbers mean that GFL would have realized a 22% return on its investment immediately upon conversion of the NMFS stock and a 20.5% return on its investment immediately upon conversion of the EquiMed stock.[5] The dollar amount of this premium would be $451,756.10 for NMFS and $1,933,493.98 for EquiMed.

Colkitt attacks the inclusion of the premium as inequitable because GFL would be recovering both "liquidated damages" and interest at a "default rate" (discussed below). The premium, however, is not part of a liquidated damages clause in the sense that term is used in the cases cited by Colkitt. A liquidated damages clause sometimes is included in a contract to allow certainty in the calculation

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[5] Reached through the following arithmetic: 18/(100-18)=0.2195 (NMFS); 17/100-17=0.2048 (EquiMed)

of damages, which otherwise might be uncertain, should a breach occur. In this case, had the contract been performed, GFL would have earned the premium through the conversion of stock for principal. The premium does not represent an attempt to quantify an otherwise uncertain amount, and the premium clauses of the notes simply represent an intention to preserve the return on investment should there be a default. In fact, all that the premium clauses do is set forth in the notes the actual damages which are suffered and which would be recoverable regardless of the inclusion of the premium clauses in the notes.

The notes contain clauses setting the interest rates at 7% (NMFS) and 4% (EquiMed) prior to default and 14% (both) after default. Colkitt contends that the legal rate of interest of 6% should apply, citing *Daset Mining Corp. v. Industrial Fuels Corp.*, 326 Pa. Super. 14, 473 A.2d 584 (Pa. Super. Ct. 1984), in support of that proposition.

In Pennsylvania, "the right to interest upon money owing upon contract is a legal right." *Fernandez v. Levin,* 519 Pa. 375, 548 A.2d 1191, 1193 (Pa. 1988)(citation omitted). The right to interest begins at the time that payment is withheld despite a duty to make payment, i.e. the contract is breached. *Id.* Pennsylvania applies RESTATEMENT (SECOND) OF CONTRACTS §354 (1981), which provides that the legal rate of interest is recoverable in the absence of a contractual provision establishing the rate of interest. *Id.* (quoting RESTATEMENT OF CONTRACTS §337(a), currently found in §354). "The award of interest in a contract action is a matter of right regardless of when it is demanded ... or whether it is demanded." *Id.* (citations omitted).

When the terms of the contract fix the rate of interest, however, that rate applies. *See McDermott v. Party City Corp.*, 11 F. Supp. 2d 612, 632-633 (E.D. Pa. 1998)(statutory rate of interest applied to claims of breached contract with no provision for interest rate, while contractual rate of interest applied to claim under promissory note with provision establishing interest at prime rate).

In *Daset*, the statutory rate of interest applied because the parties failed to make any provision for an interest rate on a note which would be applicable in the event of a breach, and the rate of interest otherwise was 6%. 473 A.2d at 597. *Daset* is inapposite in a case in which there are contractual provisions governing the rate of interest.

Colkitt also argues that there is no "default rate" of interest set forth in the notes. The notes specify, "Any amount of principal or interest in the Note which is not paid when due shall bear interest at the Rate of fourteen percent (14%) per annum from the due date thereof until the same is paid." Notes at 1. Colkitt's argument in this regard is frivolous: Regardless of how the rate is termed, "default" or otherwise, it became the rate of interest at the time that a sum became due and was not paid. Further, the default provision, which Colkitt claims does not contain the 14% rate, incorporates this provision by stating that all principal and interest became payable on default.

The interest on the NMFS note from May 24, 1996, until December 20, 1996 (the date of the default), at 7% is $82,883.84. The interest on unpaid amounts due through December 20, 1996, at 14% is $2,158.16. The interest which became due thereafter (all at 14% because the entire amount

of unpaid principal and interest became due on default), through May 31, 2000, is $1,251,048.13. Therefore, the total amount (principal and interest) due on the NMFS note as of May 31, 2000, is $3,845,846.22.

The interest on the EquiMed note from August 5, 1996, through January 6, 1997 (the date of the default), at 4% is $159,316.16. The interest on unpaid amounts due through January 6, 1997, at 14% is $2,312.96. The interest which became due thereafter (all at 14% because the entire amount of unpaid principal and interest became due on default), through May 31, 2000, is $5,486,294.17. Therefore, the total amount (principal and interest) due on the EquiMed Note as of May 31, 2000, is $17,021,417.27.

The total due on both notes as of May 31, 2000, is $20,867,263.49, and the per diem on the notes is $995.27 (NMFS) and $4,424.43 (EquiMed). As of July 17, then, which means that 47 days have elapsed since May 31, 2000, another $254,725.90 is due as interest, for a final total of $21,121,989.39 in principal and accrued interest. A judgment in that amount will be entered.

In responding to Colkitt's brief, GFL adds a sum representing attorney's fees. We think it inappropriate at this point to add that sum to the total claimed. GFL did not argue for that amount in its motion for summary judgment and accompanying brief, and did not assert that it was entitled to attorney's fees in a specific sum before the filing of Colkitt's supplemental brief relating to damages. Colkitt therefore has not had an opportunity to respond to the claim for attorney's fees, either as to whether or not they should be awarded at all

or to the sums claimed. The claim for attorney's fees will not be included in the judgment to be entered at this time.

## VI. CONCLUSION

Colkitt's motion for reconsideration will be denied. A judgment in favor of GFL in the amount of $21,121,989.39 will be entered.

An order consistent with this memorandum will issue.

/s/_____
James F. McClure, Jr.
United States District Judge

**UNITED STATES DISTRICT COURT**
**FOR THE MIDDLE DISTRICT**
**OF PENNSYLVANIA**

**No. 4: CV-97-0526**

**[Filed July 17, 2000]**

GFL ADVANTAGE FUND, LTD.,
Plaintiff,

v.

DOUGLAS R. COLKITT
Appellant.

JUDGE:
James F. McClure, Jr., United States District Judge.

**ORDER**

For the reasons stated in the accompanying memorandum, **IT IS ORDERED THAT:**

1. Defendant Douglas R. Colkitt's motion (record document no. 111) for reconsideration of our Memorandum and Order of Court dated April 25, 2000, is denied.

2. The clerk is directed to enter judgment in favor of plaintiff GFL Advantage Fund, Ltd., and against defendant Douglas R. Colkitt in the amount of $21,121,989.39.

3. The clerk is directed to close the file.

/s/_____
James F. McClure, Jr.
United States District Judge

## APPENDIX D

**UNITED STATES DISTRICT COURT**
**FOR THE MIDDLE DISTRICT**
**OF PENNSYLVANIA**

**No. 4: CV-97-0526**

**[Filed April 25, 2000]**

GFL ADVANTAGE FUND, LTD.,)
Plaintiff, )
)
v. )
)
DOUGLAS R. COLKITT )
Appellant. )
)

JUDGE:
James F. McClure, Jr., United States District Judge.

**MEMORANDUM**

**BACKGROUND:**

On April 4, 1997, plaintiff GFL Advantage Fund, Ltd., commenced this action against defendant Douglas R. Colkitt, seeking to recover under written agreements pursuant

to which Colkitt borrowed funds from GFL and agreed, *inter alia,* that GFL would have the right to exchange the principal amount of the debt for shares of National Medical Financial Services Corp. (NMFS) and EquiMed, Inc., held by Colkitt. Cotkitt filed a multi-count counterclaim against GFL alleging that it engaged in a scheme to defraud him by engaging in a scheme of concentrated short selling of shares in NMFS and EquiMed. That action would force down the market price and enable GFL to exchange the debt for shares valued at an artificially low price, then reap substantial profits when the price of the shares exchanged rebounded to former levels.

On March 31, 1998, the court adopted, with modifications, the report and recommendation of the magistrate judge to whom the case originally was assigned. Counts I, III, IV, and V of Colkitt's counterclaim were dismissed without prejudice, based on the lack of specificity of the allegations pursuant to Fed. R. Civ. P. 9(b). Count II of the counterclaim was dismissed with prejudice, subject to a motion for reinstatement should the Third Circuit recognize a cause of action under Section 17 of the Securities Act of 1933, 15 U.S.C.§77q(a). Count VI of the counterclaim was dismissed with prejudice, an action which was concluded on reconsideration to be in error, and the order was corrected to make the dismissal without prejudice.

On April 20, 1998, Colkitt filed an amended counterclaim complaint for the purpose of curing the deficiencies which led to dismissal of the original counterclaim. We again concluded that the factual allegations were insufficient to support a claim of fraud, and the amended counterclaim was dismissed without prejudice.

Jury selection currently is scheduled for July 5, 2000, with trial to commence as soon as feasible thereafter.

Before the court are a motion by GFL for summary judgment, a motion by Colkitt to compel a deposition and expert witness disclosures, a motion by Colkitt for additional discovery, and a motion by Colkitt to strike the affidavit of Robert D. Cason.

**DISCUSSION:**

## I. SUMMARY JUDGMENT STANDARD

Summary judgment is appropriate if the "pleadings, depositions, answers to interrogatories, and admissions on file, together with the affidavits, if any, show that *there is no genuine issue as to any material fact and that the moving party is entitled to judgment as a matter of law.*" Fed. R. Civ. P. 56(c) (emphasis added).

> . . .[T]he plain language of Rule 56(c) mandates the entry of summary judgment, after adequate time for discovery and upon motion, against a party who fails to make a showing sufficient to establish the existence of an element essential to that party's case, and on which that party will bear the burden of proof at trial. In such a situation, there can be 'no genuine issue as to any material fact,' since a complete failure of proof concerning an essential element of the nonmoving party's case necessarily renders all other facts immaterial. The moving party is 'entitled to

> judgment as a matter of law' because the nonmoving party has failed to make a sufficient showing on an essential element of her case with respect to which she has the burden of proof.

*Celotex Corp. v. Catrett*, 477 U.S. 317, 323-324 (1996).

The moving party bears the initial responsibility of stating the basis for its motions and identifying those protions of the record which demonstrate the absence of a genuine issue of material fact. *Celotex* at 323. He or she can discharge that burden by "showing . . . that there is an absence of evidence to support the nonmoving party's case." *Celotex* at 325.

Issues of fact are genuine "only if a reasonable jury, considering the evidence presented, could find for the non-moving party." *Childers v. Joseph*, 842 F.2d 689, 693-694 (3d Cir. 1988) (citing *Anderson v. Liberty Lobby, Inc.*, 477 U.S. 242, 249 (1986)). Material facts are those which will affect the outcome of the trial under governing law. *Anderson* at 248. The court may not weigh the evidence or make creidibility determinations. *Boyle v. County of Allegheny*, 133 F.3d 386, 393 (3d Cir. 1998). In determining whether an issue of material fact exists, the court must consider all evidence and inferences drawn therefrom in the light most favorable to the non-moving party. *Boyle* at 393; *White v. Westinghouse Electric Co.*, 862 F.2d 56, 59 (3d Cir. 1988).

If the moving party satisfies its burden of establishing a prima facie case for summary judgment, the opposing party

must do more than raise some metaphysical doubt as to material facts, but must show sufficient evidence to support a jury verdict in its favor. *Boyle* at 393 (quoting, *inter alia, Matsushita Electric Industrial Co. v. Zenith Radio Corp.*, 475 U.S. 574, 586 (1986)).

If the opposing party shows by affidavit that it cannot present facts necessary to its opposition, the motion may be denied or may be continued to permit the opposing party to obtain further affidavits or conduct further discovery. Fed. R. Civ. P. 56(f). While technical compliance with Rule 56(f)'s affidavit requirement is not essential, a party moving for a continuance still must identify with specificity what particular information is sought, how it would preclude summary judgment if uncovered, and why it has not been obtained previously. *San Filippo v Bongiovanni*, 30 F.3d 424, 432 (3d Cir. 1994), *cert. denied,* 513 U.S. 1082 (1995); *St. Surin v. Virgin Islands Daily News, Inc.*, 21 F.3d 1309, 1314 (3d Cir. 1994). When the information sought is in the hands of the party moving for summary judgment, a Rule 56(f) motion will be granted almost as a matter of course unless the information is otherwise available to the party opposing summary judgment. *San Filippo* at 432-433. A motion for a continuance under Rule 56(f) should be addressed before the motion for summary judgment is resolved. *St. Surin* at 1315.

## II. STOUT AS AN EXPERT WITNESS

We address first Colkitt's motion to compel expert witness disclosures and to depose Donald E. Stout. Colkitt contends, based on an affidavit by Stout supporting the motion for summary judgment, *see* Appendix in Support of GFL's Motion for Summary Judgment, Exhibit E, that Stout's

testimony properly constitutes opinion testimony which may be given only by an expert witness under Fed. R. Evid. 702.

Paragraphs 1 through 3 of the Stout affidavit simply provide background material concerning Stout's position, involvement in the subject transactions (which are described below in the Statement of Facts relating to the motion for summary judgment), and the status of GFL. Paragraph 4 states the relationship between Stout's employer and GFL. Paragraphs 5 through 11 summarize the agreements between the parties. Paragraphs 12 and 13 recite some of the dealings between the parties after the agreements were executed. Paragraph 14 describes the effect of Colkitt's actions and some of the conduct of GEL as a result thereof. Paragraph 15 recites the reasoning behind some of GFL's conduct. Paragraph 16 specifies the sales made by GFL designated as short sales, and Paragraph 17 indicates that these were the only short sales made by GFL, alone or in conjunction with any other entity. Paragraph 18 is a list of closing prices for NMFS and EquiMed as published by Bloomberg, L.P.

In Paragraph 19, Stout indicated that Prudential Securities, Inc., sold approximately 550,000 shares of EquiMed between November 25, 1996, and January 28, 1997. Based on Colkitt's motion and brief, which indicate an error in the computation by which Stout arrived at this figure, GFL has withdrawn Paragraph 19, and agrees with Colkitt's figure of 207,805 shares. *See* GFL's Brief in Opposition to Colkitt's Motion under Rule 56(f) at 4-5. For present purposes, we will read the affidavit as containing the correct figure.

Paragraph 20 is a list of the instances of conduct by Colkitt which GFL contends were in breach of the agreements between the parties. Paragraph 21 states that Colkitt never indicated to GFL that he suspected manipulation or a short-selling scheme prior to the filing of the answer, affirmative defenses and counterclaim in this action. Paragraph 22 is a mathematical computation of the damages alleged due to the breach. Paragraphs 23 and 24 deny any involvement by GFL in manipulation of the prices of NMFS and EquiMed, or any other unlawful scheme related to NMFS or EquiMed.

We fail to see how any of this information constitutes an expert "opinion" for purposes of Fed. R. Evid. 702. At most, the affidavit involves gathering information from particular sources and presenting it in a summary form for ease of review and comprehension. As noted by GFL, such evidence is admissible under Fed. R. Evid. 1006.

Colkitt's motion to compel expert witness disclosures and the deposition of Stout will be denied.

## III. MOTION UNDER RULED 56 (f)

Colkitt moves for additional discovery for two reasons: to obtain the expert report and to depose Stout, discussed above, and to depose A.P. DeGroot. We already have determined that the proffered testimony of Stout, as embodied in the affidavit submitted in support of the motion for summary judgment, does not constitute expert opinion testimony. Colkitt therefore is not entitled to a continuance under Rule 56(f) for purposes of obtaining discovery relating to Stout.

As to DeGroot, Colkitt contends that DeGroot's testimony is necessary to establish facts surrounding the agreements at issue. DeGroot was the president of GFL at that time the agreements were executed. According to Colkitt, he did not receive from GFL "crucial information" regarding DeGroot; specifically, DeGroot's business telephone number, which counsel for Colkitt received via correspondence from GFL's counsel dated February 2, 2000.

GFL responds first that it did not have any responsibility for providing a telephone number, having complied with the only discovery request from Colkitt relating thereto. Second, the telephone number provided was merely the specific extension for DeGroot, while a general number provided by GFL in discovery would place a caller in contact with the same business.

Under *St. Surin* and *San Filippo*, Colkitt has failed to show a good reason for not obtaining the information earlier. He never made a formal request for DeGroot's specific extension, nor has he shown that he could not contact DeGroot through the general number in his possession earlier. In fact, Colkitt nowhere indicates that he even *tried* to contact DeGroot through the general number during the discovery period.

Moreover, Colkitt sets forth only a general statement that a deposition of DeGroot would "undermine" factual assertions by GFL. There is no specific statement as to what information would be obtained for the purpose of precluding summary judgment.

Colkitt's motion pursuant to Rule 56(f) will be denied.

## IV. MOTION TO STRIKE

Colkitt moves to strike the affidavit of Robert D. Cason because it was presented for the first time in GFL's reply brief and it contradicts Cason's deposition testimony. We have not relied on the facts alleged in the affidavit, which are intended to support GFL's factual contentions relating to a "hedging" strategy. While we describe this strategy in the statement of facts below, its use or non-use by GFL is immaterial because, as discussed below, Colkitt fails to show any substantial effect on the price of the shares of NMFS or EquiMed caused by GFL's short sales. The motion to strike will be denied.

## V. STATEMENT OF FACTS

The facts recited herein have been taken generally from GFL's Statement of Undisputed Material Facts in Support of Its Motion for Final Summary Judgment. Some facts have been altered to reflect meritorious objections by Colkitt, to reflect the record more accurately or completely, to remove argumentative material, and/or for stylistic or grammatical purposes. Explanatory material, where necessary, appears in brackets.

Colkitt was the founder and majority shareholder of NMFS, holding approximately 2.8 million of the 7,426,844 shares of common stock outstanding as of May, 1996, at which time NMFS was trading at approximately $12.875 per share. EquiMed was created in February, 1996, as the result of a merger between Colkitt's wholly-owned practice management firms and Equivision, a publicly held

opthomology[6] company in which Colkitt owned a 28% interest. Colkitt owned 20,783,633 shares of the 28,589,717 shares of EquiMed common stock outstanding as of February, 1996. EquiMed was trading at approximately $14.00 per share after a contemporaneous Initial Public Offering. EquiMed decreased in price to $7.75 per share by August, 1996, the date of the GFL/EquiMed Transaction.

Despite his vast stock holdings, including without limitation his ownership interest in NMFS and EquiMed, Colkitt sought to obtain additional liquidity in the spring of 1996 in the range of $15-25 million in order to fund his aggressive entry into unrelated business ventures. Colkitt approached a number of commercial lenders in his effort to obtain this financing including, without limitation, ING Bearings, Bankers Trust, Republic Bank, and G.E. Capital. However, Colkitt did not obtain financing from any of these lenders or any other commercial bank or traditional lender in the amount desired.

Colkitt engaged Wharton Capital Corp. as his agent to locate financing sources acceptable to Colkitt. The basic financial parameters of a prospective convertible transaction, whereby Cotkitt's shares in either NMFS or EquiMed would be converted into cash, were set by Colkitt before any potential lenders were identified. Wharton identified GFL as a potential lender to Colkitt.

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[6] GFL uses the word "opthomology" in its statement of facts, probably referring to ophthalmology. "Opthomology" is not in either of the dictionaries consulted by the court. THE RANDOM HOUSE DICTIONARY OF THE ENGLISH LANGUAGE 1358, 1360 (2d ed.. 1987); DORLAND's MEDICAL DICTIONARY 1185, 1187 (28th ed. 1994).

On or about May 24, 1996, Colkitt borrowed $3,000,000.00 from GFL and executed certain transaction documents setting forth, among other things, Colkitt's repayment obligations. Said documents included the NMFS Exchangeable Note, the NMFS Registration Rights Agreement, and the NMFS Pledge Agreement.

Among other terms, the NMFS note provided GFL after 30 days with the right to exchange an amount up to one half of the original principal amount of the NMFS Note for fully paid and non-assessable shares of NMFS common stock owned by Colkitt. Beginning 60 days after the date of the NMFS Note, GFL was entitled to exchange the remaining one half of the outstanding principal amount of the NMFS Note for such shares of NMFS common stock. The NMFS Note set the exchange price at 82% of the Average Market Price of NMFS common stock, as that term is defined in the NMFS Note. The right to exchange was limited to the outstanding principal.

Colkitt also agreed to pay interest on the unpaid principal balance at a rate of 7% per annum, payable on the first day of each February, May, August, and November, beginning on August 1, 1996, and at maturity.

On or about August 5, 1996, Colkitt borrowed an additional $10,000,000.00 from GFL and executed certain transaction documents setting forth, among other things, Colkitt's repayment obligations. Said documents included the EquiMed Exchangeable Note, the EquiMed Pledge Agreement, and the EquiMed Registration Rights Agreement. Beginning 60 days after the date of the EquiMed Note, GFL had the right to exchange up to one half of the original

principal amount of the EquiMed Note for fully paid and non-assessable shares of EquiMed common stock owned by Colkitt. Beginning 90 days after the date of the EquiMed Note, GFL could exchange the remaining one half of the principal amount of the EquiMed Note for such shares of EquiMed common stock. The EquiMed Note set the exchange price at 83% of the Average Market Price of EquiMed common stock, as that term is defined in the EquiMed Note. The right to exchange was limited to the outstanding principal.

Colkitt also agreed to pay GFL interest on the unpaid principal sum at the rate of 4% per annum, payable on the first day of each February, May, August, and November, beginning on November 1, 1996, and at maturity.

The Notes provide that Pennsylvania law controls the Notes and other transaction documents entered into by and between Colkitt and GFL. Neither the EquiMed nor the NMFS transaction documents included any provision which prohibited or otherwise limited GFL from entering into a short position in the stock of either NMFS or EquiMed at any time.

Colkitt received cash from GFL at closing in the amounts of $3,000,000.00 less broker's commission in conjunction with the NMFS transaction and $10,000,000.00 less broker's commission in conjunction with the EquiMed transaction.

In order to allow GFL to sell shares which it was to receive in exchange for debt under the terms of the NMFS Note, Colkitt was required to cause NMFS to prepare and file

with the SEC a post-effective amendment to NMFS's Registration Statement on Form SB-2 within 15 days from the date of the NMFS Note, or by June 7, 1996. Colkitt failed to cause NMFS to file such a post-effective amendment with the SEC within the time required. [Colkitt disputes this recitation, claiming that (1) GFL waived the registration requirement, (2) GFL was not damaged, and (3) the failure to file was not a material breach. GFL's purported waiver is a legal argument and does not change the fact that Colkitt did not file the amendment, nor does it change the terms of the agreement. Whether GFL was damaged is a separate issue, not addressed in the fact recited. The objection to the use by GFL of the term "material breach" has been resolved by deleting it, since its use constitutes a legal argument. Colkitt also recites an argument concerning GFL's purported fraud and market manipulation which is not appropriate objection to a factual recitation. Rather, such arguments properly are raised in the context of whether GFL is entitled to judgment as a matter of law, not whether there is genuine dispute as to material facts.]

Colkitt failed to pay interest on the outstanding principal under the NMFS Note on August 1, 1996, and at any time thereafter. Colkitt failed to maintain in escrow shares of EquiMed common stock in an amount equal to not less than 150% of the current outstanding principal balance due under the EquiMed Note, as required by the transaction documents. Colkitt also failed to honor GFL's EquiMed Exchange Notice dated January 3, 1997, at which time GFL attempted to exchange $1,430,000.00 of principal into approximately 500,685 shares of EquiMed common stock. [Colkitt raises legal arguments relating to his obligation to take these actions as required under the transaction

documents. Whether or not there was a valid excuse for his failure take the actions stated, the facts remain unaltered.]

NMFS and EquiMed notified GFL on January 9, 1997, that they would no longer honor any further Exchange Notices because GFL had called a default under the applicable transaction documents. [Colkitt responds by stating, "undisputed that GFL had breach[ed] the agreements prior to January 9, 1997." Nowhere does GFL state that it breached the agreements.]

[The court has omitted the fact numbered 21 by GFL because it recites an admission by Colkitt. While the subject of an admission may be a material fact, that Colkitt made an admission is not a material fact. The subject of the purported admission is recited elsewhere in this Statement of Facts.]

The Notes contain cross-default provisions, which provide that a default under either of the Notes constitutes a default under the other Note. Colkitt specifically agreed to pay to GFL, upon default, all unpaid principal then due under the Notes, all accrued and unpaid interest on the unpaid principal balance together with an amount equal to 22% (NMFS) or 20.5% (EquiMed) of the unpaid principal balances then due under the Notes. Colkitt specifically waived demand, presentment or notice in the event of a default under the Notes. [Colkitt denies that there was a default.]

[The court has omitted the fact numbered 25 by GFL because it characterizes the actions by Colkitt as events of default and recites GFL's purported rights arising therefrom, and therefore constitutes legal argument and not a factual recitation.]

The following exchange requests were submitted to Colkitt. All were honored except as noted:

| Date of Exchange | EquiMed | NMFS |
|---|---|---|
| September 13, 1996 | | $250,000.00 principal for 34,130 shares at $7.32/share |
| Date of Exchange | EquiMed | NMFS |
| September 19, 1996 | | $135,000.00 principal for 18,726 shares at $7.21/share |
| October 10, 1996 | | $257,000.00 principal for 47,081 shares at $5.46/share |
| November 27, 1996 | $560,000.00 principal for 150,555 shares at$3.72/share | |
| December 5, 1996 | | $100,000.00 principal for 14,845 shares at $6.74/share |
| December 19, 1996 | | $200,000.00 principal for 34,588 shares at $5.78/share |
| January 3, 1997 | $1,430,000.00 principal for | |

500,685 shares
at $2.86/share
**Dishonored.**

January 7, 1997 — $2,058,000.00 principal for 100,223 shares at $5.44/share
**Withdrawn as moot.**

[Colkitt's objection to mathematical errors in the original table contained in GFL's statement of material facts has been resolved by correcting the errors. Colkitt also contends that GFL did not have exchange rights, a legal argument not proper for resolution in this context.]

Pursuant to the exchange procedures agreed upon by the parties, GFL would forward to Colkitt a "Notice of Exchange of Exchangeable Note" which would set forth, among other things, the exchange date, the dollar amount of principal balance which GFL sought to exchange, together with the number of shares which GFL was entitled to receive in exchange. Upon receiving a Notice of Exchange, it was agreed that Colkitt thereafter would process said request and forward instructions designed to release to GFL the appropriate number of shares. In a number of cases, however, the actual stock certificates received by GFL bore a restrictive legend which restricted the subsequent transfer of such shares. As a result, GFL was often required to take the additional step of requesting from the applicable transfer agent "clean," non-legend shares in exchange for the legended shares. Whether for this or other reasons, GFL did not receive physical possession of freely assignable certificates from Colkitt until approximately 11, 18, 25, 33, 34, and 46 days

after the date of the six honored Exchange Notices. [Colkitt again raises an objection relating To GFL's exchange rights which is legal, not factual, in nature, and therefore will not be addressed in this context. Also, Colkitt raises a disingenuous objection stating that he is unable to respond to the factual recitation relating to his failure to provide "clean" shares. There were only six exchange requests honored, and GFL refers to delays relating to all six exchanges. We think it a simple matter to review just six transactions to determine which involved legended shares. Regardless, the matter is of little relevance to the primary issues of whether GFL committed fraud or engaged in manipulation of the price of shares of NMFS and/or EquiMed.]

The price of each exchanged share of stock was "locked in"at a five-day average of the stock immediately prior to the date of the Exchange Notice. [Colkitt objects to this fact, stating that the term "locked in" is not defined. The meaning is obvious both from the ordinary meanings of the words used and the context: the price to be paid for the shares did not change from the 5-day average multiplied by the applicable exchange rate.] The risk of a decrease in the price of the converted stock therefore was shifted from Colkitt to GFL as of the date of the conversion request. [Colkitt's limited objection does not alter the fact recited.]

According to GFL, in order to hedge against the risk of a price decrease, and otherwise to take advantage of current market conditions, GFL entered into the following short sales:

NMFS

| Date | Closing Price | Shares Sold | Price Change from Prior Day |
|---|---|---|---|
| 9/13/96 | $10.00 | 32,500 | +1 3/8 |
| 9/16/96 | 9.13 | 15,000 | -7/8 |
| 9/17/96 | 9.25 | 5,000 | +1/8 |
| 10/11/96 | 8.25 | 3,000 | +1/4 |

| Date | Closing Price | Shares Sold | Price Change from Prior Day |
|---|---|---|---|
| 10/14/96 | 8.25 | 7,000 | no change |

EQUIMED

| Date | Closing Price | Shares Sold | Short Sale Price | Change from Prior Day |
|---|---|---|---|---|
| 11/8/96 | $5.25 | 18,400 | 10,000-$5.50<br>8,400- 5.48 | - 1/4 |
| 11/11/96 | 5.25 | 32,500 | 5.38 | no change |
| 11/12/96 | 5.00 | 16,000 | 5.25 | - 1/4 |
| 11/14/96 | 5.25 | 8,500 | 5.25 | +1/4 |
| 11/22/96 | 5.13 | 3,300 | 5.00 | +3/8 |

[Colkitt objects to this recitation for several reasons. First, he contends that GFL's hedging strategy is a pretext. That does not change the recitation or our characterization of what GFL contends its strategy was. The chart produced by GFL has been amended to reflect the prices at which the EquiMed short sales were made. The remainder of the objection is legal argument.]

GFL did not engage in any other short trade, either for its own account or in conjunction with any other affiliate or unrelated third party, except as set forth in the tables above. [Colkitt states that he needs to depose DeGroot with respect to this fact. As discussed above, he has not demonstrated a basis for further discovery. We also note in this context that there is no reason another representative of GFL could not have been questioned on this issue during the depositions taken during the discovery period.]

The average closing price of NMFS showed an increase between January, 1996, and May, 1996, but then declined steadily between May 1996 and January, 1998. The decline was from a peak of $12.875 on May 1, 1996, to a low of $0.4375 on January 2, 1998. The average closing price of EquiMed showed a similar pattern, peaking on February 1, 1996, at $15.00, then declining to a low of $2.4583 on January 2, 1998. [Colkitt objects to a chart produced by GFL reflecting these patterns. The court has used a summary rather than reproduce the chart. Colkitt contends that there is no foundation for the prices in GFL's chart. Actually, the chart is provided in the affidavit cited by GFL, i.e. that the prices are taken from those published by Bloomberg. Colkitt also points out that every day's closing price is not given. A chart

need not be so detailed to show the downward trend in the value of both stocks.]

Colkitt has no independent knowledge of how many shares GFL actually shorted in NMFS and EquiMed, and his suspicions concerning GFL were based, in large part, upon information which he received "third hand, double hearsay probably..." Colkitt never disclosed to GFL his alleged suspicions that GFL was engaged in a manipulative market scheme of any kind until Colkitt filed his answer, affirmative defenses and counterclaim in this action on June 5, 1997. [Colkitt states that he attempted-to prepay prior to this time, but GFL refused. The prepayment issue is discussed below. Regardless, we fail to see how Colkitt's attempt at prepayment refutes the fact that he did not disclose his suspicions to GFL prior to the filing of his answer, affirmative defenses and counterclaim; an attempt at prepayment does not indicate suspicions of a manipulative market scheme.] Colkitt attempted to negotiate the prepayment of the Notes in December 1996, and January, 1997.

GFL claims damages totaling $20,043,469.73 as of December 31, 1999.

## VI. COLKITT'S BREACH

GFL contends that Colkitt breached the agreements in four ways, including: (1) failing to cause NMFS to file the requisite amendment to its registration statement; (2) failing to maintain in escrow the requisite level of pledged EquiMed stock; (3) failing to pay quarterly interest; and (4) failing to honor GFL's exchange requests. Colkitt rationally cannot,

and does not, argue that these actions were not required under the terms of the agreements nor that he did take these actions. The question is whether Colkitt's breach of the agreements is excused either because the agreements are invalid or because performance by Colkitt was waived by GFL.

## VII. FRAUD AND MARKET MANIPULATION

Colkitt offers two reasons to excuse his breach of the agreements between the parties. First, he claims that GFL committed fraud by inducing him to enter into the agreements when it intended to short sell NMFS and EquiMed stock to drive down the price, hereby profiting greatly when the price rebounded after the exchange. Second, he claims that the short selling in itself was a scheme to manipulate the market. Both of these actions, according to Colkitt, are in violation of Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 promulgated thereunder. 15 U.S.C. §78j(b); 17 C.F.R. §240.10b-5. Further, Colkitt argues that these violations render the agreements void under Section 29(b) of the Act, 15 U.S.C. §78cc(b), and therefore unenforceable by GFL. (Colkitt asserts a similar defense under the Pennsylvania Securities Act which parallels the federal defense.)

Both parties cite *In re Olympia Brewing Co. Securities Litigation,* 613 F. Supp. 1286, 1292 (N.D. Ill. 1985), for the principle that short selling is not illegal *per se,* but may be unlawful if it is part of a scheme to manipulate the market. The court explained:

> Furthermore, the court reminds plaintiffs that short selling is simply not unlawful, even in

> large numbers and even if the trading does negatively affect the purchase price. Where the trading volume and prices simply reflect supply and demand based on accurate market information, this is lawful market behavior, not market manipulation. Hence, evidence of substantial short selling is necessary to plaintiffs' claims, but certainly does not prove them. Where the selling appears in all other respect to be lawful, the court will not draw the inference that an unlawful conspiracy to manipulate the market price took place.

*Id.* at 1296.

Despite the party's lengthy briefs, use of calculations such as percentages of daily sales versus monthly sales, etc., the theory espoused by Colkitt fails for one simple reason: he has failed to produce any evidence that the short selling by GFL had any substantial effect on the price of NMFS or EquiMed shares. That is, there is a simple causation problem which undermines all of Colkitt's arguments.

The decline in the price of NMFS began in May, 1996, well before the short sales of that stock by GFL in September, 1996. The decline continued through 1997 and into 1998. The decline in the price of EquiMed began in February, 1996, again well before any short sales of that stock by GFL in November, 1996. Colkitt fails to provide any evidence that the declines in price are attributable to false information injected into the market by the short sales and not to information otherwise available to the market. *See generally In re Scattered Corp. Securities Litigation,* 844 F.

Supp. 416, 420 (N.D. Ill. 1994) (market manipulation under Rule 10b-5 refers to practices intended to mislead investors by artificially affecting market activity; quoting *Santa Fe Indus., Inc. v. Green,* 430 U.S. 462, 476 (1977)), *aff'd sub nom. Sullivan & Long, Inc. v. Scattered Corp.*, 47 F.3d 857 (7th Cir.), *reh'g en banc denied, cert. denied sub nom. Harkins v. Scattered Corp.*, 516 U.S. 818 (1995) .

GFL points to other information available to the trading public which is likely to have had an adverse effect on any securities with which Colkitt was associated. While Colkitt objects to this information as an attempt to portray him in a negative light, we need not decide the question of its accuracy or even review the specifics of the information. The fact is that there were other factors and other information publicly available which could have affected the prices of NMFS and EquiMed. This information would be in addition to any objective value of the companies themselves, apart from their association with Colkitt.

What Colkitt fails to provide is any evidence which supports a conclusion that there would have been no decline in the price of NMFS and/or EquiMed, or at least a substantially smaller decline, but for the short sales by GFL. As described by the court in *Olympia Brewing*, 613 F. Supp. at 1297, there is not sufficient evidence of any scheme of market manipulation in a few instances of short selling, particularly when the price actually rose during some of the short selling. On the days of GFL's short selling, there was little or no change in the price of shares of NMFS and EquiMed, and several of the changes included small increases in the price of the shares.

In short, there is no evidence that the short sales by GFL had any substantial effect on the price of the shares, and therefore the mere fact of short selling does not prove a scheme to manipulate the market. It follows that, absent evidence of a scheme to manipulate the market, GFL cannot be said to have intended to engage in such a scheme, and its failure to disclose such a scheme does not support Colkitt's contention regarding fraud.

Colkitt's breach of the agreements is not excused by any fraud or market manipulation by GFL because a finding of such conduct is not supported in this record.

## VIII. TENDER OF PREPAYMENT

Colkitt next contends that there was a prior breach by GFL when it refused his offer to prepay all principal and interest due on the Notes. As we have stated previously, GFL never rejected the offer of prepayment outright. Rather, it accepted the offer of prepayment as representing the undisputed portion of the obligation, but reserved its rights with respect to the disputed portion of the debt so as to avoid a claim of accord and satisfaction. Order of Court dated November 5, 1999, at 2-3. In contrast to Colkitt's contention that the agreements do not allow GFL to accept an offer of prepayment conditionally, nothing in the agreements requires GFL to accept prepayment in an amount unilaterally imposed by Colkitt.

GFL's acceptance while reserving its rights to the disputed amount does not constitute a breach of contract.

## IX. CONCLUSION

Colkitt's motion to compel an expert witness report and the deposition of Stout will be denied because the proffered testimony of Stout is not of such nature that it may be offered only through a witness designated as an expert. Colkitt's motion for a continuance to conduct discovery under Rule 56(f) will be denied for the same reason, and because Colkitt has failed to demonstrate a good reason for not obtaining the information sought previously nor has he specified how the deposition of DeGroot would preclude the entry of summary judgment.

Colkitt's motion to strike the affidavit will be denied because the affidavit does not affect disposition of the motion for summary judgment.

The record plainly demonstrates that Colkitt failed to comply with his obligations under the terms of the parties' agreements, as set forth in the transaction documents. His breach is not excused by any conduct on the part of GFL. GFL's motion for summary judgment will be granted.

GFL alleges a sum it claims as damages, and Colkitt did not challenge the amount. We believe we therefore could enter judgment in that amount. However, in an abundance of caution, so that Colkitt may properly address the matter, we will allow further briefing on the issue of damages, as we did in the *Berckeley* litigation.

An order consistent with this memorandum will issue.

/s/_____
James F. McClure, Jr.
United States District Judge

**UNITED STATES DISTRICT COURT**
**FOR THE MIDDLE DISTRICT**
**OF PENNSYLVANIA**

**No. 4: CV-97-0526**

**[Filed April 25, 2000]**

GFL ADVANTAGE FUND, LTD.,)
Plaintiff, )
)
v. )
)
DOUGLAS R. COLKITT )
Appellant. )

JUDGE:
James F. McClure, Jr., United States District Judge.

**ORDER**

For the reasons stated in the accompanying memorandum,

**IT IS ORDERED THAT:**

1. Defendant Douglas R. Colkitt's motion (record document no. 93) to compel the deposition of Donald E. Stout and expert witness disclosures under Rule 26(a) is denied.

2. Colkitt's motion (record document no. 95) pursuant to Rule 56(f) is denied.

3. Colkitt's motion (record document no. 106) to strike the affidavit of Robert D. Cason is denied.

4. Plaintiff GFL Advantage Fund, Ltd.'s motion (record document no. 87) for final summary judgment is granted.

5. The entry of final judgment is deferred pending determination of the amount of damages.

6. Colkitt shall file, on or before May 12, 2000, a brief responsive to the amount of damages claimed by GFL. *See* GFL's Statement of Material Facts at 10 ¶ 37 and supporting documentation.

7. GFL may file a reply brief on or before May 26, 2000.

## APPENDIX E

## CONSTITUTIONAL AND STATUTORY PROVISIONS

## CONSTITUTION OF THE UNITED STATES OF AMERICA

## ARTICLE III. JUDICIAL POWER

### Sec. 2, Cl 1. Subjects of jurisdiction

The judicial Power shall extend to all Cases, in Law and Equity, arising under this Constitution, the Laws of the United States, and Treaties made, or which shall be made, under their Authority;--to all Cases affecting Ambassadors, other public Ministers and Consuls;--to all Cases of admiralty and maritime Jurisdiction;--to Controversies to which the United States shall be a Party;--to Controversies between two or more States;--between a State and Citizens of another State;--between Citizens of different States,--between Citizens of the same State claiming Lands under Grants of different States, and between a State, or the Citizens thereof, and foreign States, Citizens or Subjects.

### Sec. 2, Cl 2. Jurisdiction of Supreme Court

In all Cases affecting Ambassadors, other public Ministers and Consuls, and those in which a State shall be Party, the supreme Court shall have original Jurisdiction. In all the other Cases before mentioned, the supreme Court shall have appellate Jurisdiction, both as to Law and Fact, with

such Exceptions, and under such Regulations as the Congress shall make.

**Sec. 2, Cl 3. Trial by jury**

The Trial of all Crimes, except in Cases of Impeachment, shall be by Jury; and such Trial shall be held in the State where the said Crimes shall have been committed; but when not committed within any State, the Trial shall be at such Place or Places as the Congress may by Law have directed.

## TITLE 28. JUDICIARY AND JUDICIAL PROCEDURE
## PART IV. JURISDICTION AND VENUE
## CHAPTER 85. DISTRICT COURTS; JURISDICTION

### 28 USCS § 1332 (2001)

§ 1332. Diversity of citizenship; amount in controversy; costs

(a) The district courts shall have original jurisdiction of all civil actions where the matter in controversy exceeds the sum or value of $ 75,000, exclusive of interest and costs, and is between--

(1) Citizens of different States;

(2) citizens of a State and citizens or subjects of a foreign state;

(3) citizens of different States and in which citizens or subjects of a foreign state are additional parties; and

(4) a foreign state, defined in section 1603(a) of this title [28 USCS §1603(a)], as plaintiff and citizens of a State or of different States.

For the purposes of this section, section 1335, and section 1441, an alien admitted to the United States for permanent residence shall be deemed a citizen of the State in which such alien is domiciled.

## TITLE 15. COMMERCE AND TRADE
## CHAPTER 2B. SECURITIES EXCHANGES

### 15 USCS §§ 78j (2001)

§§ 78j. Manipulative and deceptive devices

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange--

(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, or any securities-based swap agreement (as defined in section 206B of the Gramm-Leach-Bliley Act [15 USCS §§ 78c note]), any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

Rules promulgated under subsection (b) that prohibit fraud, manipulation, or insider trading (but not rules imposing or

specifying reporting or recordkeeping requirements, procedures, or standards as prophylactic measures against fraud, manipulation, or insider trading), and judicial precedents decided under subsection (b) and rules promulgated thereunder that prohibit fraud, manipulation, or insider trading, shall apply to security-based swap agreements (as defined in section 206B of the Gramm-Leach-Bliley Act [15 USCS §§ 78c note]) to the same extent as they apply to securities. Judicial precedents decided under section 17(a) of the Securities Act of 1933 [15 USCS §§ 77q(a)] and sections 9, 15, 16, 20, and 21A of this title [15 USCS §§§§ 78i, 78o, 78p, 78t, and 78u-1], and judicial precedents decided under applicable rules promulgated under such sections, shall apply to security-based swap agreements (as defined in section 206B of the Gramm-Leach-Bliley Act [15 USCS §§ 78c note]) to the same extent as they apply to securities.

## TITLE 15. COMMERCE AND TRADE
## CHAPTER 2B. SECURITIES EXCHANGES

### 15 USCS §§ 78cc (2001)

§§ 78cc. Validity of contracts

(b) Contract provisions in violation of title. Every contract made in violation of any provisions of this title or of any rule or regulation thereunder, and every contract (including any contract for listing a security on an exchange) heretofore or hereafter made, the performance of which involves the violation of, or the continuance of any relationship or practice in violation of, any provision of this title or any rule or regulation thereunder, shall be void (1) as regards the rights

of any person who, in violation of any such provision, rule, or regulation, shall have made or engaged in the performance of any such contract, and (2) as regards the rights of any person who, not being a party to such contract, shall have acquired any right thereunder with actual knowledge of the facts by reason of which the making or performance of such contract was in violation of any such provision, rule or regulation: Provided, (A) That no contract shall be void by reason of this subsection because of any violation of any rule or regulation prescribed pursuant to paragraph (3) of subsection (c) of section 15 of this title [15 USCS §§ 78o(c)(3)], and (B) that no contract shall be deemed to be void by reason of this subsection in any action maintained in reliance upon this subsection, by any person to or from whom any broker or dealer sells, or from or for whom any broker or dealer purchases, a security in violation of any rule or regulation prescribed pursuant to paragraph (1) or (2) of subsection (c) of section 15 of this title [15 USCS §§ 78 o(c)(1) or (2)], unless such action is brought within one year after the discovery that such sale or purchase involves such violation and within three years after such violation. The Commission may, in a rule or regulation prescribed pursuant to such paragraph (2) of such section 15(c) [15 USCS §§ 78o(c)(2)], designate such rule or regulation, or portion thereof, as a rule or regulation, or portion thereof, a contract in violation of which shall not be void by reason of this subsection.

## APPENDIX F

## UNITED STATES DISTRICT COURT FOR THE MIDDLE DISTRICT OF PENNSYLVANIA

**No. 4: CV-97-0526**

**[Dated January 4, 2000]**

GFL ADVANTAGE FUND, LTD.,)
Plaintiff, )
)
v. )
)
DOUGLAS R. COLKITT )
Defendant. )
)

### AFFIDAVIT OF DONALD E. STOUT

STATE OF WASHINGTON )
) SS
COUNTY OF KING )

I Donald E. Stout, being duly sworn upon my oath, hereby states as follows:

1. I have been employed by Genesee Services Corporation or an affiliate thereof since June, 1994. I am

currently employed by Genessee Services Corporation as a senior financial analsyt.

2. I have been personally involved with, and have personal knowledge of the Colkitt transactions which are the subject of the above captioned action. This includes without limitation, (i) involvement with these transactions at the time these two deals were negotiated and booked; (ii) participation in the subsequent exchange requests; and (iii) participation in GFL's overall post-default strategy, including continuous monitoring of publically available market information pertaining to both NMFS and Equimed.

3. GFL Advantage Fund, Ltd. ("GFL") is a corporation existing under the laws of the British Virgin Islands. Its principle place of business is Kava ???? **Caracao, Netherlands Antilles.**

4. Genesee Services Corporation provides administrative accounting and all other necessary support services required by GFL. Genesee Services Corporation maintains its principal place of business at 10500 N.E. 8th Street, Suite 1920, Bellevue, Washington, 98004-4332.

5. On or about May 24, 1996, Colkitt borrowed $3,000,000.00 from GFL and executed certain transaction documents setting forth, among other things, Colkitt's repayment obligations. Said documents included, without limitation, the NMFS Exchangeable Note (the "NFMS Note"), the NMFS Registration Rights Agreement and the NMFS Pledge Agreement, copies of whic are attached to the Appendix ("the Appendix") as Exhibits "C," "I" and "S".

6. Beginning thirty days after the date of the NMFS Note, GFL had the right to exchange up to one-half of

the original principal amount of the NMFS Note for fully paid and non-assessable shares of NMFS common stock owned by Colkitt. Beginning sixty days after the date of the NMFS Note, GFL was entitled to exchange the remaining one half fo the outstanding principal amount of the NMFS note for shares of NMFS common stock. The exchange price agreed to by Colkitt and GFL set forth in the NMFS Note was 82% of the Average Market Price of NMFS common stock, as that term is defined in the NMFS note (Notes, ¶ 2.2).

7. Colkitt also agreed to pay, in addition to the principal sum, interest on the unpaid principal balance at a rate of 7% per annum, payable on the first day of each February, May, August, and November, beginning on August 1, 1996, and at maturity. (Notes, ¶ 1).

8. On or about August 5, 1996, Colkitt borrowed an additional $10,000,000.00 from GFL and executed certain transaction documents setting forth, among other things, Colkitt's repayment obligations. Said documents, included, without limitation, the EquiMed Exchangeable Note (the "Equimed Note" sometimes referred to with the NMFS Note as "the Notes"), the EquiMed Pledge Agreement and the EquiMed Registration Rights Agreement, copies of which are attached to the Appendix as Exhibits "D", "G" and "T".

9. Beginning sixty days after the date of the EquiMed Note, GFL had the right to exchange up to one-half of the original principal of the EquiMed Note for fully paid and non-assessable shares of EquiMed common stock owned by Colkitt. GFL could exchange the remaining one-half of the principal amount of the EquiMed Note beginning ninety days after the date of the EquiMed Note. Colkitt and GFL, agreed, and the EquiMed Note established the exchange price at 83% of the Average Market Price of EquiMed common

stock, as that term is defined in the EquiMed Note. (Notes, ¶ 2.2).

10. Colkitt also agreed to pay GFL, in addition to the principal, interest on the unpaid principal sum at the rate of 4% per annum, payable on the first day of each February, May, August, and November beginning on November 1, 1996, and at maturity. (Notes, ¶ 1).

11. The parties agreed that in order for GFL to exchange principle to shares under the Notes, GFL would forward a letter to Colkitt (the "Exchange Notice") setting forth, among other things, the dollar amount of principle balance which GFL sought to exchange at the time, together with the number of shares which GFL was entitled to receive in exchange. The exact number of shares which GFL was entitled to receive would be computed by GFL as of the day of the Exchange Notice, pursuant to the formula set forth in the Notes — 82% of the average market price of NMFS common stock for the five (5) consecutive trading days ending one trading day prior to the date of the Exchange Notice, 83% of the average market price for EquiMed. The Exchange Price was locked in as of the date of the Exchange Notice, notwithstanding any subsequent movement in the market price of the subject stock.

12. Upon reviewing an Exchange Notice from GFL, it was agreed that Colkitt would thereafter process said request and forward instructions designed to release to GFL the appropriate number of shares. In a number of cases however, the actual stock certificates received GFL have a restrictive legend which restricted the subsequent transfer of such shares. As a result, GFL was often required to take the additional step of requesting from the applicable transfer agent "clean," non-legended shares in exchange for the

legended shares. Whether for this or other reasons, GFL did not receive physical possession of freely assignable certificates from Colkitt until approximately 11, 18, 25, 33, 34 and 46 days after the date of the six honored Exchange Notices. This far exceeded GFL's contemporaneous experience, whereby GFL typically received freely assignable certificates in similar exchangeable transactions within 3 to 7 business days of an exchange request.

13. The following exchange requests were submitted to Colkitt. All were honored except as noted.

**CONVERSIONS**

| Date of Exchange | EquiMed | NMFS |
|---|---|---|
| September 13; 1996 | | $250,000.00 principal exchange for 34,130 shares at $4.31/share |
| September 19, 1996 | | $135,000.00 principal exchange for 18,726 shares at $4.49/share |
| October 10, 1996 | | $257,000 principal exchange for 47,081 shares at $4.00/share |

| | | |
|---|---|---|
| November 27, 1996 | $560,000 principal exchange for 18,726 shares at $4.19/share | |
| December 5, 1996 | | $100,000 principal exchange for 14,845 shares at $4.38/share |
| December 19, 1996 | | $200.000 principal exchange for 14,588 shares at $4.00/share |
| January 3, 1997 | $1,430,000 principal exchange for 500,685 shares at $4.06/share **Dishonored** | |
| January 7, 1997 | | $2,058,000 principal exchange for 100.225 shares at $4.00/share **Withdrawn as moot**. |

14. The price of each exchanged share of stock was "locked in" pursuant to the aforementioned formula as of the date of the Exchange Notice. GFL therefore assumed the risk associated with a subsequent price decrease in the subject stock. The additional time delay which resulted from the aforementioned restrictive legends exacerbated this risk as

GFL was unable to liquidate its position for an extended period of time after the date of the Exchange Notice, notwithstanding potentially favorable market conditions. This clearly required GFL to engage in a short selling hedge strategy designated to minimize this risk.

15. It is GFL's practice to review each component of its portfolio on a regular basis. In addition to the aforementioned hedge strategy, GFL may at times sell a stock short if market conditions warrant and GFL as the right to convert shares but does not then possess "long" shares in its portfolio to sell. Hence, rather than undertake numerous, small exchanges, GFL also took a limited short position in NFMS and EquiMed in certain instances when it did not hold a stock long, but price and daily volume nevertheless presented favorable conditions for a limited sale of stock. These favorable market conditions would have been lost if GFL would have had to short exchange.

16. GFL's short sales in NMFS and EquiMed were limited to the following ten trading days:

**NMFS**

| Date | Closing Price | Shares Sold | Price Change from Prior Day |
|---|---|---|---|
| 9/13/96 | $10.00 | 32,500 | +1 3/8 |
| 9/16/96 | 9.13 | 15,000 | -7/8 |
| 9/17/96 | 9.25 | 5,000 | +1/8 |
| 10/11/96 | 8.25 | 3,000 | +1/4 |
| 10/14/96 | 8.25 | 7,000 | no change |

**EQUIMED**

| Date | Closing Price | Shares Sold | Short Sale Price | Change from Prior Day |
|---|---|---|---|---|
| 11/8/96 | $ 5.25 | 18,400 | 10,000- $5.50<br>8,400- 5.48 | -1/4 |
| 11/11/96 | 5.25 | 32,500 | 5.38 | no change |
| 11/12/96 | 5.00 | 16,000 | 5.25 | -1/4 |
| 11/14/96 | 5.25 | 8,500 | 5.25 | +1/4 |
| 11/22/96 | 5.13 | 3,300 | 5.00 | +3/8 |

17. GFL did not sell short either NMFS or EquiMed, in its own name or in conjunction with anyone else, except as specifically set forth above.

18. I have also reviewed publicly available market information concerning NMFS and EquiMed as part of my responsibilities. This information includes, without limitation, market date made available to the public by Bloomberg, L.P. Among other things, Bloomberg provides to the investing public is the daily closing price of publicly traded stocks, including NMFS and EquiMed. The following information was reported by Bloomberg:

| Date | EquiMed | NMFS |
|---|---|---|
| 01/02/96 | $12.5000 | $ 9.1250 |
| 02/01/96 | $15.0000 | $ 9.2500 |
| 03/01/96 | $14.0000 | $10.7500 |
| 04/01/96 | $12.8750 | $12.2500 |
| 05/01/96 | $ 8.0000 | $12.8750 |
| 05/24/96 | $ 8.1250 | $12.0000 |
| 06/03/96 | $ 9.0000 | $11.1250 |
| 07/01/96 | $ 8.3750 | $ 7.2500 |
| 08/01/96 | $ 8.0000 | $ 9.2500 |

| | | |
|---|---|---|
| 09/03/96 | $ 7.3750 | $10.1250 |
| 09/09/96 | $ 7.6250 | $ 9.6250 |
| 10/01/96 | $ 7.2500 | $ 7.0000 |
| 10/15/96 | $ 7.2500 | $ 7.8750 |
| 11/01/96 | $ 5.5000 | $ 7.1250 |
| 11/08/96 | $ 5.2500 | $ 9.2500 |
| 11/22/96 | $ 5.1250 | $ 8.1250 |
| 12/02/96 | $ 4.1875 | $ 8.7500 |
| 12/27/96 | $ 3.6250 | $ 6.8125 |
| 01/02/97 | $ 3.5000 | $ 7.1250 |
| 01/09/97 | $ 3.9687 | $ 8.7500 |
| 02/03/97 | $ 4.0313 | $ 8.9531 |
| 03/03/97 | $ 4.1250 | $ 8.7500 |
| 04/01/97 | $ 3.4375 | $ 4.5000 |
| 05/01/97 | $ 2.7500 | $ 3.7500 |
| 06/02/97 | $ 3.4375 | $ 4.2500 |
| 07/01/97 | $ 1.8438 | $ 3.3750 |
| 08/01/97 | $ 2.7188 | $ 3.2500 |
| 09/02/97 | $ 2.9063 | $ 3.0000 |
| 10/01/97 | $ 3.5833 | $ 2.3750 |
| 11/03/97 | $ 2.9688 | $ 1.3750 |
| 11/13/97 | $ 2.9167 | $ 1.4375 |
| 12/07/97 | $ 3.0417 | $ 0.8125 |
| 01/02/98 | $ 2.4583 | $ 0.4375 |

19. I have also reviewed the information produced by numerous brokerage firms subpoened by Colkitt in this action, including trade run reports produced by Prudential Securities, Inc. ("Prudential"). These trade run reports, which reflect, among other things, trades executed by Prudential of EquiMed stock, appear to indicate that Keystone Financial, Inc. sold approximately **NUMBER** shares of EquiMed between November 25, 1996 and January 28, 1997 (Prudential trade run reports, App. Tab "K").

20. Colkitt failed to comply with his various obligations due GFL as set forth in the various transaction documents by, among other things:

a) Colkitt failed to cause NMFS to file with the SEC a Post-Effective Amendment to the NMFS Registration Statement on Form SB-2, whithin fifteen days after the date of the NMFS Note, (or by June 8, 1996), as required by paragraph 2(a) of the NMFS Registration Rights Agreement (thereby preventing GFL from trading any shares received in exchange under the NMFS Note).

b) Colkitt failed to maintain requisite pledge of EquiMed stock, which according to Section 3.2 of the EquiMed Pledge Agreement, was to be maintained at a level of no less than 150% of the then outstanding principal balance of the EquiMed Note. Colkitt defaulted on this obligation on or before November, 1996, and, despite demand, failed to cure this default at any time thereafter. (See, letter from Christopher R. **Purrier** to Douglas Colkitt dated November 15, 1996, App. Tab "U").

c) Colkitt failed to make required quarterly interest payments when due on the full amount of the outstanding principal balance under both of the Notes.

d) Colkitt refused to honor GFL's valid conversion request on January 3, 1997. The January 7, 1997, conversion request was withdrawn as moot, given Colkitt's default. Colkitt further advised the applicable transfer agents and GFL, on or about January 9, 1997 that nor further GFL exchange requests would be honored at any time thereafter

which was also in violation of Colkitt's contractual obligations.

21. Prior to the filing of Colkitt's Answer, Affirmative Defenses and Counterclaim on June 5, 1997, neither Colkitt nor any representative or agent of Colkitt ever advised GFL in any manner whatsoever that Colkitt believed or suspected that GFL, alone or in concert with others, had engaged in any manipulative behavior or short-selling scheme in the stock of NFMS or EquiMed.

22. Except as set forth herein, Colkitt has failed to repay GFL the amounts due under the Notes. As a result of Colkitt's breaches, GFL has sustained the following damages:

**I. NMFS**

| | |
|---|---|
| Principal | $2,058,000.00 |
| Premium (agreed upon by the parties via the discount market) | 451,756.10 |
| Accrued interest at Note rate (7%): May 24, 1996-December 20, 1996 | 82,883.84 |
| Past due interest at default rate (14%): August 1, 1996-December 20, 1996 | 2,158.16 |
| Post-default interest (14)%: December 21, 1996-December 31, 1999 | 1,099.767.84 |
| TOTAL DUE UNDER NMFS NOTE | $3,694,565.94 |

**II. EQUIMED**

| | |
|---|---|
| Principal | $9,440,000.00 |
| Premium (agreed upon by the parties via the discount market) | 1,933,493.98 |
| Accrued interest at Note rate (4%): August 5, 1996-January 6, 1997 | 159,316.16 |

| | |
|---|---|
| Past due interest at default rate (14%): November 1, 1996-January 6, 1997 | 2,312.96 |
| Post-default interest (14)%: January 7, 1997-December 31, 1999 | 4,813,780.69 |
| TOTAL DUE UNDER NMFS NOTE | $16,348,903.79 |

**TOTAL DUE UNDER BOTH NOTES AS OF DECEMBER 31, 1999 $20,043,469.73**

23. At no time did GFL or any of its affiliates engage in, or direct others to engage in conduct designed to manipulate the price of NMFS or EquiMed.

24. At no time did GFL engage in or take part in any unlawful scheme, itself or with others, to profit from the manipulation of the price of NMFS or EquiMed.

/s/_____
Donald E. Stout

Sworn in and subscribed before me this
14 day of January, 2000.

/s/_____
Amanda R. Fleig
Notary Public

My Commission Expires 11/29/03

## APPENDIX G

THE SECURITIES REPRESENTED BY THIS CERTIFICATE HAVE NOT BEEN REGISTERED UNDER THE SECURITIES ACT OF 1933, AS AMENDED. THE SECURITIES HAVE BEEN ACQUIRED FOR INVESTMENT AND MAY NOT BE SOLD, TRANSFERRED OR ASSIGNED IN THE ABSENCE OF AN EFFECTIVE REGISTRATION STATEMENT FOR THE SECURITIES UNDER THE SECURITIES ACT OF 1933, AS AMENDED, OR AN OPINION OF COUNSEL THAT REGISTRATION IS NOT REQUIRED UNDER SAID ACT.

### EXCHANGEABLE NOTE

New York, New York $10,000,000.00
August 5, 1996

FOR VALUE RECEIVED, DOUGLAS R. COLKITT, M.D. (hereinafter called the "Borrower"), hereby promises to pay to GFL Advantage Fund Limited, c/o Genesee International, 10500 N.E. 8th Street, Suite 1920, Bellevue, Washington 98004-4332, or registered assigns (the "Holder") or order, the sum of Ten Million Dollars ($10,000,000.00), on August 5, 1998, and to pay interest on the unpaid principal balance hereof at the rate of four percent (4%) per annum from the date hereof until the same becomes due and payable, whether at maturity or upon acceleration or by prepayment or otherwise. Any amount of principal of or interest on this Note which is not paid when due shall bear interest at the rate of fourteen percent (14%) per annum from

the due date thereof until the same is paid. Interest shall commence accruing on the date hereof and shall be payable on the 1st day of each February, May, August, and November, commencing November 1, 1996, and at maturity. All payments of principal of and premium, if any, and interest on this Note shall be made in lawful money of the United State of America, or, at the option of the Borrower and subject to the provisions of this Note, in whole or in part in fully paid and nonassessable shares of Common Stock, $.0001 par value, of Equimed, Inc., a Delaware corporation (the "Company"), as such stock exists on the date of issuance of this Note, or any shares of capital stock of the Company into which such stock shall hereafter be changed or reclassified (the "Common Stock"). All payments shall be made by wire transfer of immediately available funds to such account as the Holder may from time to time designate by written notice made in accordance with the provisions of this Note.

Payment and performance of this Note is secured pursuant to a Pledge Agreement, dated as of July 31, 1996 (the "Pledge Agreement"), by and between the Borrower and GFL Advantage Fund Limited ("Advantage").

The following terms shall apply to this Note:

## ARTICLE I

## CERTAIN CASH PAYMENTS IN LIEU OF CASH INTEREST

1.1 Delivery of Common Stock in Lieu of Cash Interest. (a) The Borrower shall have the right, upon the terms and subject to the conditions herein provided to exercise its option to make a payment of interest on this Note wholly

or partly in shares of Common Stock (hereinafter sometimes called the "Stock Payment Option").

(b) The Borrower shall not be permitted to exercise the Stock Payment Option with respect to any payment of interest on this Note if:

(i) the delivery of shares of Common Stock pursuant to the Stock Payment Option or the public resale of such shares by the Holder would require registration with or approval of any governmental authority under any law or regulation, and such registration or approval has not been effected or obtained; provided, however, that with respect to compliance with the securities or blue sky laws of the states of the United States, the requirements of this clause (i) shall be deemed satisfied if at the applicable time the Company is in compliance with Section 3(d) of the Registration Rights Agreement, dated as of July 31, 1996, by and between the Company and Advantage (the "Registration Rights Agreement");

(ii) the shares of Common Stock to be issued upon exercise of the Stock Payment Option have not been authorized for listing, upon official notice of issuance, on any national or regional securities exchange on which the Common Stock is ther listed; or have not been approved for quotation if traded in the over-the-counter market;

(iii) an Event of Default has occurred and is continuing or has not been waived;

(iv) the Common Stock is neither (i) listed or admitted for trading on a national securities

exchange not (ii) quoted on the Nasdaq National Market or the Nasdaq SmallCap Market; or

(v) the issuance of shares of Common Stock in payment of interest on this Note would result in any Advantage Person (as defined in Section 2.1 hereof) beneficially owning more than 4.9% of the Common Stock, determined as provided in the proviso to the first sentence of Section 2.1 hereof.

(c) If the Stock Payment Option is elected, the Borrower shall dispatch or cause to be dispatched to the Holder one or more certificates for the aggregate number of whole shares of Common Stock determined by dividing the per share Computed Price of the Common Stock into the total amount of lawful money of the United States of America which the Holder would receive if the aggregate amount of interest on this Note which is being paid in shares of Common Stock were being paid in such lawful money. No fractional shares will be issued in payment of interest on this Note. In lieu thereof, the Borrower may issue a number of shares of Common Stock which reflects a rounding up to the next whole number or may pay lawful money of the United States of America. The shares of Common Stock issued or to be issued by the Borrower in payment of interest on this Note are sometimes referred to hereinafter as the "Payment Shares."

(d) If the Borrower exercises the Stock Payment Option with respect to a payment of interest on this Note, the Borrower shall deliver to the Holder, on or prior to the date on which Payment Shares for such payment of interest on this Note are to be dispatched to the Holder, a Borrower Certificate setting forth (i) the total amount of the interest payment to which the Holder is entitled, (ii) the portion of the interest payment being made in Payment

Shares, (iii) the number of Payment Shares allocable to such payment, as calculated pursuant to the Section 1.1, (iv) any rounding adjustment to such number or any payment necessary to be made pursuant to Section 1.1(c), (v) a brief statement of the facts requiring such adjustment, (vi) the number of Payment Shares issuable with respect to each $100 of interest on this Note after such adjustment and (vii) a brief statement that none of the conditions set forth in Section 1.1(b) has occurred an is existing. Such Officer's Certificate shall be accompanied by the certificates and instruments, each duly issued in the name of the Holder, representing the Payment Shares. Such Borrower Certificate shall be conclusive evidence of the correctness of the calculation of the number of Payment Shares allocable to the payments to which such Borrower Certificate relates and of any adjustments to such number made pursuant to this Section 1.1 in the absence of manifest error. In addition, on or before the pertinent payment date, the Borrower shall cause the transfer agent for the Common Stock to prepare and issue the certificates representing the Payment Shares in the name of the Holder before being so delivered by the Borrower.

(e) The Payment Shares, when dispatched pursuant to and in compliance with this Section 1.1, shall be validly issued, fully paid and nonassessable shares of Common Stock; the issuance and delivery thereof is in all respects hereby authorized; and the dispatch thereof, together with lawful money of the United State of America, if any, paid in lieu of fractional shares of such Common Stock, will be, and for all purposes shall be deemed to be, in full discharge and satisfaction of the Borrower's obligation to pay the interest on this Note to which such Payment Shares relate.

(f) As used in this Section 1.1, the following terms shall have the meanings provided herein:

(1) "Borrower Certificate" means a certificate signed by the Borrower.

(2) "Closing Price" as of any date means the last reported bid price for one share of the Common Stock on such date at 4:00 p.m., New York City time, as reported, quoted or determined by the first applicable among the following: (a) the national securities exchange on which the shares of Common Stock are listed which constitutes the principal securities market for the Common Stock, (b) the Nasdaq National Market or (c) the Nasdaq SmallCap Market.

(3) "Computed Price" means 83% of the price equal to the arithmetic average of the per share Closing Price of the Common Stock for the five (5) consecutive trading days ending on the third trading day prior to the applicable payment date.

## ARTICLE II

## EXCHANGE RIGHTS

2.1 Exchange Right. The Holder shall have first the right (a) with respect to one-half of the original principal amount of this Note, from and after the date which is 60 days after the date of this Note and (b) with respect to the remaining one-half of the original principal amount of this Note, from and after the date which is 90 days after the date of this Note and then in either case at any time on or prior to the day this Note is paid in full, to exchange at any time all or from time to time any part of the outstanding and unpaid principal amount of this Note of at least $100,000, or such lesser amount as shall remain unpaid at the time of the

exchange, for fully paid and nonassessable shares of Common Stock owned by the Borrower at the exchange price determined as provided herein (the "Exchange Price"), provided, however, that in no event shall Advantage be entitled at any time to exchange any portion of the principal amount of this Note in excess of that portion of the principal amount of this Note upon exchange of which the sum of (1) the number of shares of Common Stock beneficially owned by Advantage and any person whose beneficial ownership of shares of Common Stock would be aggregated with Advantage's beneficial ownership of Common Stock for purposes of Section 13(d) of the Securities Exchange Act of 1934, as amended (the "Exchange Act"), and Registration 13D-G thereunder (each an "Advantage Person" and collectively, the "Advantage Persons") (other than shares of Common Stock deemed beneficially owned through the ownership of the unexchanged portion of the principal amount of this Note) and (2) the number of shares of Common Stock issuable upon exchange of the portion of the principal amount of this Note with respect to which the determination in this proviso is being made, would result in beneficial ownership by any Advantage Person of more than 4.9% of the outstanding shares of Common Stock. For purposes of the proviso to the immediately preceding sentence, beneficial ownership shall be determined in accordance with Section 13(d) of the Exchange Act and Regulation 13D-G thereunder, except as otherwise provided in clause (1) of the proviso to the immediately preceding sentence. Upon the surrender of this Note, accompanied by a Notice of Exchange of Exchangeable Note substantially in the form attached hereto as Exhibit A, properly completed and duly executed by the Holder (an "Exchange Notice"), the Borrower, shall within three business days after such surrender of this Note with the Exchange Notice (or a copy thereof if such Exchange Notice has theretofore been sent to the Company), deliver to or upon

the order of the Holder (1) that number of shares of Common Stock for the portion of the Note exchanged as shall be determined in accordance herewith, (2) a new Note in the form hereof for the balance of the principal amount hereof, if any, and (3) payment of the accrued and unpaid interest on the portion of the principal amount of this Note so exchanged. The number of shares of Common Stock to be issued upon each exchange of this Note shall be determined by dividing that portion of the principal amount of the Note to be exchanged by the Exchange Price in effect on the date the Exchange Notice is delivered to the Borrower by the Holder. If the Borrower shall fail to deliver the certificates for shares of Common Stock transferable to the Holder upon an exchange of this Note or a portion hereof within such three-day period, the Holder shall be entitled to the immediate release to it of such number of shares of Common Stock from the lien of the Pledge Agreement without further notice to the Borrower. The obligation of the Borrower to deliver shares of Common Stock or exchange of this Note shall not be limited to the shares of Common Stock which may be pledged from time to time pursuant to the Pledge Agreement.

2.2 Exchange Price. The Exchange Price shall be 83% of the Average Market Price for the five (5) consecutive trading days ending one trading day prior to the date the Exchange Notice is received by the Borrower. If the Registration Statement required to be filed by the Company pursuant to Section 2(a) of the Registration Rights Agreement is not effective within 90 days after the Closing Date, then the percentage stated above in this section 2.2 to be used in determining the Conversion Price shall be reduced by three percentage points on each Computation Date; provided that, if the period between the date on which such Registration Statement is declared effective (the "Last Computation Date") and the most recent preceding Computation Date is less than

30 days, the reduction of the Conversion Price on the Last Computation Date shall be pro-rated.

As used in this Section 2.2, the following terms shall of such number of shares of Common Stock have the following meanings:

"Average Market Price" for any period shall be computed as the arithmetic average of the Closing Prices (as defined in Section 1.1) of the Common Stock for each trading day in such period.

"Computation Date" means (1) the date which is 90 days after the Closing Date, unless the Registration Statement required to be filed by the Company pursuant to Section 2(a) of the Registration Rights Agreement theretofore has been declared effective by the SEC, (2) if the Registration Statement required to be filed by the Company pursuant to Section 2(a) of the Registration Rights Agreement has not thereto fore been declared effective by the SEC, each date which is 30 days after a Computation Date and (3) if the Registration Statement required to be filed by the Company pursuant to Section 2(a) of the Registration Rights Agreement is not declared effective by the SEC within 90 days after the Closing Date, the date on which such Registration statement is declared effective.

2.3 Authorized Shares. The Borrower covenants that during the period the exchange right exists, the Borrower will not pledge, assign, transfer, hypothecate or grant any participation in the shares of Common Stock pledged to secure this Note, which shares shall be available for transfer to the Holder on exercise of exchange rights. The Borrower represents and warrants that upon transfer ro the Holder upon exercise of exchange rights, the Holder will acquire good and

valid title to such shares free and clear of any claims, liens, equities or encumbrances.

2.4 Method of Exchange. Except as otherwise provided in this Note or agreed by the Holder, this Note may be exchanged by the Holder in whole at any time or in part from time to time by (1) submitting to the Borrower an Exchange Notice and (ii) surrendering this Note at the address of the Borrower applicable under Section 4.2 at the time of such surrender within three trading days after submission of such Exchange Notice. Upon partial exercise of the exchange rights provided hereby, a new Note containing the same date and provisions as this Note shall be issued by the Borrower to the Holder for the principal balance of this Note which shall not have been exchanged. This Note has been issued pursuant to the Note Purchase Agreement. By its acceptance of this Note, the Holder agrees to be bound by the terms of the Note Purchase Agreement. This Note has been issued by the Borrower pursuant to the exemption from registration under the Act provided by Regulation D thereunder.

## ARTICLE III

## EVENTS OF DEFAULT

If any of the following events of default (each, an "Event of Default") shall occur:

3.1 Failure to Pay Principal or Interest. The Borrower fails (a) to pay the principal hereof when due, whether at maturity, upon redemption, upon acceleration or otherwise or (b) to pay any installment of interest hereon when due and, in the case of this clause (b) only , such failure continues for a period of three (3) days after the due date thereof;

3.2 Exchange and the Shares. The Borrower fails to transfer shares of Common Stock to the Holder upon exercise by the Holder of the exchange rights of the Holder in accordance with the terms of this Note, the Company fails to transfer any certificate for shares of Common Stock issued to the Holder upon exchange of this Note as and when required by this Note or the Registration Rights agreement, or fails to remove any restrictive legend on ay certificate for any shares of Common Stock transferred by the holder upon exchange of this note as and when required by this Note, the Note Purchase Agreement or the Registration Rights Agreement;

3.3 Breach of Covenant. The Borrower breaches any material covenant or other material term or condition of this Note (other than as specifically provided in Sections 3.1 and 3.2 hereof), the Note Purchase Agreement or the Pledge Agreement or the Company breaches any material covenant or other material term or condition of the Registration Rights Agreement, and in any such case such breach continues for a period of ten business (10) days after written notice thereof to the Borrower from the Holder;

3.4 Breach of Representations and Warranties. Any representation or warranty of the Borrower made herein or in any agreement, statement or certificate given in writing pursuant hereto or in connection herewith (including, without limitation, the Note Purchase Agreement or the Pledge Agreement) or any representation or warranty of the Company made in the Registration Rights Agreement or in any agreement, statement or certificate given in writing pursuant to the Registration Rights Agreement or in connection therewith shall be false or misleading in any material respect when made;

3.5 Certain Voluntary Proceedings. The Borrower, the Company or any material subsidiary of the Company shall commence a voluntary case or other proceeding seeking liquidation, reorganization or other relief with respect to itself or its debts under any bankruptcy, insolvency or other similar law now or hereafter in effect or seeking the appointment of a trustee, receiver, liquidator, custodian or other similar official of it or any substantial part of its property, or shall consent to any such relief or to the appointment of or taking possession by any such official in an involuntary case or other proceeding commenced against it, or shall make a general assignment for the benefit of creditors, or shall fail generally to pay its debts as they become due or shall admit in writing its inability generally to pay its debts as they become due;

3.6 Judgments. Any money judgment, writ or similar process shall be entered or filed against the Borrower, the Company or any subsidiary of the Company or any of their respective properties or other assets for more than $250,000, and shall remain unvacated, unbonded or unstayed for a period of twenty (20) days;

3.7 Certain Involuntary Proceedings. An involuntary case or other proceeding shall be commenced against the Borrower, the Company or any material subsidiary of the Company seeking liquidation, reorganization or other relief with respect to it or its debts under any bankruptcy, insolvency or other similar law now or hereafter in effect or seeding the appointment of a trustee, receiver, liquidator, custodian or other similar official of it or any substantial part of its property, and such involuntary case or other proceeding shall remain undismissed and unstayed for a period of sixty (60) consecutive days;

3.8 Pledge Agreement. The Pledge Agreement or any provision thereof shall cease to be in full force or effect, or the Borrower or any person acting by or on behalf the Borrower shall deny or disaffirm the Borrower's obligations under the Pledge Agreement or the Borrower shall default in the due performance or observance of any term, covenant or agreement on its part to be performed or observed pursuant to the Pledge Agreement; or

3.9 Default Under Other Agreements. (a) the Borrower shall (i) default in any payment with respect to any indebtedness (other than the Note) which indebtedness has a principal amount of in excess of $100,000 individually or $150,000 in the aggregate beyond the period of grace, if any, provided in the instrument or agreement under which such indebtedness was created or (ii) default in the observance or performance of any agreement, covenant or condition relating to any such indebtedness or contained in any instrument or agreement evidencing, securing or relating thereto, or any other event shall occur or condition exist, the effect of which default or other event or condition is to cause, or the permit the holder or holders of such indebtedness (or a trustee or agent on behalf of such holder or holders) to cause, any such indebtedness to become due prior to its stated maturity and such default or event shall continue beyond the period of grace, if any, provided in the instrument or agreement under which such indebtedness was created (after giving effect to any consent or waiver obtained and then in effect thereunder); or (b) any such indebtedness of the Borrower shall, in accordance with its terms, be declared to be due and payable, or required to be prepaid other than by a regularly scheduled or required payment prior to the stated maturity thereof;

then upon the occurrence and during the continuation of any Event of Default specified in Section 3.1, 3.2, 3.3, 3.4, 3.6,

3.8 or 3.9 at the option of the Holder hereof, the Borrower shall, and upon the occurrence of any event of default specified in Section 3.5 or 3.7, the Borrower shall, pay to the Holder an amount equal to the sum of (1) the unpaid principal amount of this Note plus (2) an amount equal to 20.5 percent of the unpaid principal amount of this Note, plus accrued and unpaid interest on the unpaid principal amount of this Note to the date of payment and all other amounts payable hereunder shall immediately become due and payable, all without demand, presentment or notice, all of which hereby are expressly waived, together with all costs, including, without limitation, legal fees and expense, of collection, and the Holder shall be entitled to exercise all other rights and remedies available at law or in equity.

## ARTICLE IV

## MISCELLANEOUS

4.1 Failure or Indulgency Not Waiver. No failure or delay on the part of the Holder in the exercise of any power, right or privilege hereunder shall operate as a waiver thereof, nor shall any single or partial exercise of any such power, right or privilege preclude other or further exercise thereof or of any other right, power or privileges. All rights and remedies existing hereunder are cumulative to, and not exclusive of, any rights or remedies otherwise available.

4.2 Notices. Any notice herein required or permitted to be given shall be in writing and may be personally served, sent by telephone line facsimile transmission or delivered by courier or sent by United States mail and shall be deemed to have been given upon receipt if personally served, sent by telephone line facsimile transmission or sent by courier or three (3) days after being deposited in the United States mail,

certified, with postage pre-paid and properly addressed, if sent by mail. For the purposes hereof, the address of the Holder shall be as shown on the first page of this Note (telephone line facsimile transmission number 703-476-7711); and the address of the Borrower shall be 2171 Sandy Drive, State College, Pennsylvania 16803, (telephone line facsimile transmission number 814-238-4632). Both the Holder and the Borrower may change the address for service by service of written notice to the other as herein provided.

4.3 Amendment Provision. The term "Note" and all reference thereto, as used throughout this instrument, shall mean this instrument as originally executed, or if later amended or supplemented, then as so amended or supplemented.

4.4 Assignability. This Note shall be binding upon the Borrower and its hers, executors, administrators and successors, and shall inure to be the benefit of the Holder and its successors and assigns. This Note and the rights and obligations of the Borrower hereunder may not be assigned by the Borrower.

4.5 Cost of Collection. If default is made in the payment of this Note, the Borrower shall pay the Holder hereof costs of collection, including Attorney's fees.

4.6 Governing Law. This Note shall be governed by the internal laws of the Commonwealth of Pennsylvania, without regard to the principles of conflict of laws.

IN WITNESS WHEREOF, Borrower has caused this Note to be signed in its name by its duly authorized officer on the day and in the year first above written.

/s/_____
Douglas R. Colkitt, M.D.

## EXHIBIT A

## NOTICE OF EXCHANGE OF EXCHANGEABLE NOTE

TO: DOUGLAS R. COLKITT, M.D.

(1) Pursuant to the terms of the Exchangeable Note (the "Note"), the undersigned hereby elects to exchange $____ principal amount of the Note for shares of Common Stock of EQUIMED, INC., a Delaware corporation (the "Borrower"). Capitalized terms used herein and not otherwise defined herein have the respective meanings provided in the Note.

(2) Please transfer a certificate or certificates for the number of shares of Common Stock for which such principal amount of the Note is exchangeable in the name(s) specified immediately below, or if additional space is necessary, on an attachment hereto:

| _____ | _____ |
|---|---|
| Name | Name |
| _____ | _____ |
| Address | Address |
| _____ | _____ |
| SS or Tax ID Number | SS or Tax ID Number |

(3) In the event of partial exercise, please reissue an appropriate Note for the principal balance which shall not have been exchanged. Capitalized terms used in this Notice of Exchange and not otherwise defined herein shall have the respective meanings provided in the Note.

(4) If the shares of Common Stock transferable upon exchange of the Note have not been registered under the Securities Act of 1933, as amended (the "Act"), the undersigned represents and warrants that (i) such shares of Common Stock are being acquired for the account of the undersigned for investment, and not with a view to, or for resale in connection with, the distribution thereof, and that the undersigned has no present intention of distributing or reselling such shares and (ii) the undersigned is an "accredited investor" as defined in Regulation D under the Act.

Date_____

_____

Signature of Registered Holder
(Must be signed exactly as name appears in the Note.)